the CATO JOURNAL

AN INTERDISCIPLINARY JOURNAL OF PUBLIC POLICY ANALYSIS

MARKETS, PROTECTIONISM, AND THE FUTURE OF TRADE

Charles P. Kindleberger	International Trade and National Prosperity *Comment by* **Edward Tower**
Leland B. Yeager and David G. Tuerck	Realism and Free-Trade Policy *Comment by* **Ronald A. Krieger**
Melvyn Krauss	Protectionism, the Welfare State and the Third World
Victor A. Canto	U.S. Trade Policy: History and Evidence *Comment by* **Sidney L. Jones**
Paul Heyne	Do Trade Deficits Matter?
Thomas D. Willett and Mehrdad Jalalighajar	U.S. Trade Policy and National Security *Comment by* **Earl C. Ravenal**
J. Michael Finger	The Political Economy of Trade Policy *Comment by* **Subroto Roy**
Steve H. Hanke	U.S.-Japanese Trade: Myths and Realities *Comment by* **Gary Hufbauer**
Murray L. Weidenbaum	The High Cost of Protectionism

OTHER ARTICLES

Dwight R. Lee	Constitutional Reform: A Prerequisite for Supply-Side Economics
Thomas Greider	Instream Flows: The State and Voluntary Action
Douglas A. Houston	Deregulating Electric Utilities: A Market-Process Approach
E. C. Pasour, Jr.	Information: A Neglected Aspect of the Theory of Price Regulation

VOLUME 3 NUMBER 3 • PUBLISHED BY THE CATO INSTITUTE • WINTER 1983/84

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the CATO JOURNAL

VOLUME 3 NUMBER 3 • PUBLISHED BY THE CATO INSTITUTE • WINTER 1983/84

Editor
JAMES A. DORN

Production
DAVID LAMPO
JOSE MONTESERIN

EDITORIAL BOARD

TERRY L. ANDERSON
Montana State University

CHARLES W. BAIRD
California State University
at Hayward

T. E. BORCHERDING
Claremont Graduate School

YALE BROZEN
University of Chicago

JAMES M. BUCHANAN
Center for Study of
Public Choice
George Mason University

EDWIN DIAMOND
Massachusetts Institute
of Technology

ARTHUR A. EKIRCH
State University
of New York at Albany

RICHARD A. EPSTEIN
University of Chicago

STEVE H. HANKE
Johns Hopkins University

C. LOWELL HARRISS
Columbia University

FRIEDRICH A. HAYEK
University of Freiburg

LEONARD P. LIGGIO
Institute for
Humane Studies

SAM PELTZMAN
University of Chicago

ALVIN RABUSHKA
Hoover Institution
Stanford University

EARL C. RAVENAL
Georgetown University

VERNON L. SMITH
University of Arizona

JOHN W. SOMMER
University of Texas–Dallas

THOMAS SZASZ
State University of New York
Upstate Medical Center

ROLAND VAUBEL
Mannheim University

KAREN I. VAUGHN
George Mason University

LAWRENCE H. WHITE
New York University

LELAND B. YEAGER
University of Virginia

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The CATO JOURNAL (ISSN 0273-3072) is published in the spring, fall, and winter by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003. Annual subscriptions are $15.00 for both individuals and institutions. Single copies are $5.00. Two-year subscriptions are $27.00 and three-year subscriptions are $36.00. Foreign subscribers should add $5.00 per year for regular delivery and $10.00 per year for airmail delivery.

Correspondence regarding subscriptions, changes of address, procuring back issues, advertising and marketing matters, etc., should be addressed to the Publications Department. All other correspondence, including requests to quote or reproduce material, should be addressed to the editor.

Unsolicited manuscripts cannot be returned and will be acknowledged only if accompanied by a stamped, self-addressed envelope. There is no submission fee. Articles should focus on specific public policy issues. Accepted manuscripts must conform to the CATO JOURNAL's style requirements. (A style sheet is available on request.)

Authors should submit three copies of their papers or communications to the editor. An abstract of no more than 250 words should also be included to aid referees. Manuscripts should have wide margins and be double-spaced throughout, including footnotes.

Unsolicited book reviews cannot be returned and will be acknowledged only if they are accepted for publication. They should conform to the above requirements, and should provide an in-depth analysis of major studies of public policy. Reviews should not exceed 4,000 words.

The views expressed by the authors of the articles are their own and are not attributable to the editor, the editorial board, or the Cato Institute.

The CATO JOURNAL is regularly abstracted in *Current Contents/ Social and Behavioral Sciences* and *Social Sciences Citation Index*, both produced by the Institute for Scientific Information. The CATO JOURNAL is also indexed and abstracted in the ABI/ INFORM database. The CATO JOURNAL is available on microfilm from University Microfilms International, Ann Arbor, Michigan 48106.

Printed in the United States of America.

Copyright © 1983 by the Cato Institute.
All rights reserved.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

MARKETS, PROTECTIONISM, AND THE FUTURE OF TRADE

Charles P. Kindleberger
International Trade and National Prosperity 623

Comment by **Edward Tower** 639

Leland B. Yeager and David G. Tuerck
Realism and Free-Trade Policy 645

Comment by **Ronald A. Krieger** 667

Melvyn Krauss
Protectionism, the Welfare State and the Third World 673

Victor A. Canto
U.S. Trade Policy: History and Evidence 679

Comment by **Sidney L. Jones** 697

Paul Heyne
Do Trade Deficits Matter? 705

Thomas D. Willett and Mehrdad Jalalighajar
U.S. Trade Policy and National Security 717

Comment by **Earl C. Ravenal** 729

J. Michael Finger
The Political Economy of Trade Policy 743

Comment by **Subroto Roy** 751

Steve H. Hanke
U.S.-Japanese Trade: Myths and Realities 757

Comment by **Gary Hufbauer** 771

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Murray L. Weidenbaum
The High Cost of Protectionism 777

OTHER ARTICLES

Dwight R. Lee
Constitutional Reform: A Prerequisite for Supply-Side Economics 793

Thomas Greider
Instream Flows: The State and Voluntary Action 811

Douglas A. Houston
Deregulating Electric Utilities: A Market-Process Approach 831

E. C. Pasour, Jr.
Information: A Neglected Aspect of the Theory of Price Regulation 855

COMMUNICATIONS

Richard Auster
Privatization, Justice and Markets 869

Reply by **Steve H. Hanke** 873

John R. Lott
A Note on Law, Property Rights, and Air Pollution 875

BOOK REVIEWS

The Supply-Side Solution
Edited by Bruce Bartlett and Timothy P. Roth
Reviewed by **Dwight R. Lee** 879

Development Without Aid
Melvin B. Krauss
Reviewed by **Doug Bandow** 882

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

INTERNATIONAL TRADE AND NATIONAL PROSPERITY

Charles P. Kindleberger

In writing about foreign trade over the years, I have churned out a fairly complex set of ideas dealing with the relationships between trade and growth. More exports can either stimulate or retard growth; more imports, too, can either stimulate or retard growth. A reduction in exports or imports may also spur or slow the growth of an economy. If we start from the other end, more growth may limit or increase exports, and equally may lead to a gain or decline in imports.[1] A standard joke in my classes, repeated year after year to what I trust is the delight of successive generations of students, is that the answer to every question in economics is "it depends." The answer to the immediately following question, which you can supply, is usually "on the elasticities." In the present case, however, whether more or fewer exports or imports speed or slow growth depends on something rather different, namely the nature of the ongoing growth.

Keynesian versus Schumpeterian Growth

Some years ago, Henry Wallich, in his academic incarnation, differentiated between Keynesian and Schumpeterian growth.[2] Keynesian growth assumes a given state of the arts, as it was called in

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Ford International Professor of Economics Emeritus at the Massachusetts Institute of Technology, Cambridge, Mass. 02139. He is also President-Elect of the American Economic Association.

[1]See Charles P. Kindleberger, "Foreign Trade and Economic Growth, Lessons from Britain and France, 1850–1913, *Economic History Review* 14 (December 1961): 285–305; idem, "Foreign Trade and Growth: Lessons from British Experience since 1913," *Lloyds Bank Review* 65 (July 1962): 16–28; and idem, *Foreign Trade and the National Economy* (New Haven: Yale University Press, 1962), chaps. 11–12.

[2]Henry Wallich, *The Monetary Problems of an Export Economy* (Cambridge, Mass.: Harvard University Press, 1950).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

F. W. Taussig's day, or fixed technology. More exports stimulated growth through the foreign-trade multiplier, as increased incomes in the export sector resulted in increased spending throughout the economy; and increased growth from domestic spending spilled over into more imports. More exports typically improved the balance of payments; increased domestic spending worsened it, even though the effect on national prosperity of an equal dose of export or domestic spending would be the same. An increase in imports arising from new industries abroad hurts income and prosperity as domestic output is displaced and jobs are lost.

In a Schumpeterian model, on the other hand, growth comes from innovation that tends to be export-increasing and import-decreasing. Innovation in export lines—new products or new ways of producing old products—stimulates foreign trade, while innovation leading to import-substitution—generally new ways of producing existing products—reduces it. In either case the balance of payments is improved.

Perhaps the most interesting cases involving the Schumpeterian model are those in which more exports hurt national prosperity and more imports enhance it. Great Britain provides a telling example of the first. I have argued that in turning its export trade away from the competitive markets of Europe and the United States in the last third of the 19th century, and concentrating on exporting more traditional goods—cotton textiles, ships, steel rails, galvanized iron sheets and the like—to the Empire, Britain missed out on the electrical, automotive, and chemical industries beginning to burgeon on the Continent and in the United States.[3] More of the same was a recipe for slowdown in a stage of economic menopause or climacteric, achieving Keynesian perhaps but evading Schumpeterian growth. In France, on the other hand, more imports under the Cobden-Chevalier treaty of commerce of 1860 stimulated the conversion of the iron industry from charcoal to coal and accelerated technical catch-up in cotton textiles.[4] Unfortunately, nature abhors controlled experiments, and credit for the economic growth enjoyed by France in the two decades before the Franco-Prussian War of 1870 must be shared with the spread of the railroad system in the 1850s and 1860s, the stimulus to public works from the innovation of industrial banking by the Crédit Mobilier and its imitators, and the discoveries of gold in California and Australia.

[3]See Kindleberger, "Foreign Trade and Economic Growth."

[4]Arthur L. Dunham, *The Anglo-French Treaty of Commerce of 1860 and the Progress of the Industrial Revolution in France* (Ann Arbor: University of Michigan Press, 1930).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

A peculiar case resulting from the same treaty can be found in Coventry, England. There, cheap imports of French silk ribbon killed a struggling import-competing industry, adding to existing unemployment in the watch industry, caused by earlier French and Swiss innovations unmatched in the backward English trade. In the short run, this was painful; in the long run, it established the basis for economic success. Skilled workers from the watch industry and abundant, relatively unskilled labor from the silk-ribbon industry made Coventry a suitable place in which to start the manufacture of bicycles, a dynamic industry in the 1880s. It was this transformation that by the turn of the century furnished the nucleus for the British automobile industry.[5]

The debate in Britain two decades ago over whether to join the Common Market centered on some important questions. Would competition from imports set back weak industries (a Keynesian model)? Would access to markets on the Continent energize the strong? And most important, would increased imports from the Continent stimulate lagging British industries to cut costs and learn to grow, or merely lead to their demise (a Schumpeterian model)? My colleague, Dean Abraham Siegel, is fond of recounting a visit to the Foreign Office in London at about this time, where he met an economic official opposed to entry who said, "Not every kick in the pants galvanizes, you know. Some just hurt."

How does one learn whether an economy is poised on the edge of Schumpeterian growth or has relapsed—I think it fair to call it a relapse—into Keynesian growth in which the drive to innovate has flagged? Most economies have both: the new industries of high technology and the old, sometimes characterized by smokestacks, in which technical change has slowed to a walk. What the net effect of the two is may well differ, depending upon whether one uses employment or value-added as weights.

Olson's Hypothesis: The Role of Special Interests

A hint as to the functioning of the total economy was recently furnished by Mancur Olson, who examines the extent to which an economy is beset by interest groups or "distributional coalitions."[6] These groups organize to use political instead of economic power to raise prices and increase their real incomes, without adding to their

[5]John Prest, *The Industrial Revolution in Coventry* (London: Oxford University Press, 1960).

[6]Mancur Olson, *Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

overall productivity—a point also made by Lester Thurow.[7] Olson believes that the longer a society continues with unchanged boundaries and without the shock of revolution or defeat in war, the more encrusted it becomes with these coalitions and the more incapable of responding to economic challenges at home and abroad. Political agendas become crowded, slowing down decision making. Vested interests block one another, impeding action. He asserts that the miraculous growth of Germany and Japan after World War II is ascribable in considerable measure to the fact that the dictatorships of the 1930s, plus defeat in war and occupation by the victors, dissolved the interests that could block advance. Instead of individuals and firms relying on their cartel, lobby, union, or other organization to advance their interests, it was necessary to work hard alone. Young countries, relatively unhampered by distributional coalitions, are readier to innovate, to reallocate resources from one industry to another, to meet competition from abroad with cost reduction, and are less prone to inflation, and to reach for the remedy of protectionism.

The Free-Trade Movement in Britain and Northern Europe

Let me acknowledge immediately that free trade, like tariff protection, has cogently been characterized as a design of particular interests, as much as or more than the result of enlightened thought and economic teaching. It is well known that the Anti-Corn Law League in Great Britain represented the cotton manufacturers of Manchester. They opposed tariffs and wanted cheap imports of grain to hold down wages and the cost of living and to slow down industrialization on the Continent by encouraging farming there. They hoped that by importing more grain from Europe, they could sell Europe more cloth. A number of historians call this "free-trade imperialism."[8] Friedrich List, the German protectionist of the 19th century, characterized evangelical free trade as the tactic of the climber who gets to the top of the wall and kicks away the ladder to prevent others from following him up.[9]

If one takes an especially Spenglerian view of tariff history, he can see two broad cycles toward and away from free trade: the first led by Britain, which sponsored the Industrial Revolution; the second

[7]Lester Thurow, *The Zero-Sum Society* (New York: Basic Books, 1981).

[8]John Gallagher and Ronald Robinson, "The Imperialism of Free Trade," *Economic History Review* 6 (1953): 1–15.

[9]See Friedrich List, *The National System of Political Economy* (1842), trans. Sampson S. Lloyd (London: Longmans, Green, and Co., 1904).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

by the United States after it had emerged strengthened from World Wars I and II. In both cases, the country had been protectionist in the century before and had also benefited from the protection afforded by a major war.

The free-trade movement in Britain was not fundamentally a response to the arguments of Adam Smith. The manufacturing classes first won the right to vote in the Reform Bill of 1832, then undertook "fiscal reform" that simplified thousands of duties, repealed the Corn Laws, and moved to free trade generally. The rest of Europe, but not the United States, followed suit, moved partly by such export interests as the Junkers with their large grain farms, partly by ideology, and partly by extraneous considerations of foreign policy. Napoleon III, for instance, agreed to the Anglo-French Commercial Treaty of 1860 over the protests of all the interest groups in France except the relatively weak export groups—Bordeaux in wine, Lyons in silk, and Paris in jewelry and similar luxuries.

The free-trade movement produced its most drastic changes in northern Europe. Tariff reduction went well beyond the confines of repeal of the Corn Laws to abrogation of the Navigation Acts of the 17th century, removal of the preferential timber duties that favored Canada over Scandinavia and the United States, and ultimately brought protection down to the level of tariffs for revenue only—that is, on products such as sugar, tobacco, wine, brandy, and the like, not produced in the British Isles. Trade liberalization set off a surge of exports from Sweden to Great Britain—largely oats for the horses of London,[10] plus timber and high-grade iron[11]—and led to a large increase in Norwegian shipping.[12] It also prepared Denmark (and the Netherlands) for the rise in exports of animal products—butter, cheese, bacon, eggs, and the like—for which the demand in Britain increased with rapidly rising income.[13] In world economic history there is no better illustration of export-led growth.

This free-trade movement lasted from about 1840 to 1875. But Great Britain clung to free trade until after World War I, an example

[10]Gunnar Fridlizius, *Swedish Corn Exports in the Free Trade Era: Patterns in the Oats Trade, 1850–1880* (Lund: G. W. K. Gleerup, 1957).

[11]Arthur G. Montgomery, *The Rise of Modern Industry in Sweden* (London: P. S. King, 1939); Lars Jörberg, "Structural Change and Economic Growth in Nineteenth-Century Sweden," in *Sweden's Development from Poverty to Affluence, 1750–1970,"* ed. Steven Koblik (Minneapolis: University of Minnesota Press, 1975).

[12]Victor D. Norman, "Trade Liberalization and Industrial Growth: The Impact of British Trade Liberalization in the 1840s on Industrialization in the Scandinavian Countries," unpublished term paper, Massachusetts Institute of Technology, 17 December 1970.

[13]Einar Jensen, *Danish Agriculture: Its Economic Development* (Copenhagen: Munksgaard, 1937), chap. 12.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

in some views of cultural lag or conditioned reflex that dominated the vested interests. The same sort of lag will be encountered again in U.S. tariff history. Germany, France, Italy, and Sweden adopted tariffs largely, the guess may be hazarded, because Britain had lost its leadership role and was turning away from Europe politically and economically, and beginning to close itself in the Empire. British pressure for free trade, intense from the 1840s to 1870s on the Continent, was less and less felt.[14]

In this view, free trade, like world peace and world monetary stability, is a public good that needs an enforcer to flourish. The fallacy of composition—that the whole is less than the sum of the parts when the parts interact, and even a negative good or a bad—means that any one country may gain (in its terms of trade, perhaps in the balance of payments, or in avoiding the necessity to transfer politically powerful resources out of an existing industry) from imposing a tariff; but when all countries restrict trade, international trade declines and all lose. Unless there is an enforcer of free trade—some country that wants free trade for itself and twists arms to get others to follow suit—the fact that each country may gain separately from a tariff, or may be forced to adopt protection by dominant interests, produces a negative result overall.

The Free-Trade Movement in America

When Britain no longer provided the leadership, example, and arm-twisting to keep Europe in line on free trade, the United States took over in the 20th century. In this second of tariff cycles, the timing of the start is uncertain and may be said to have begun with the Reciprocal Trade Agreement Act of 1934, or more certainly in 1941 with the Atlantic Charter, Article 7 of the Lend-Lease Agreements; and postwar with the International Trade Organization, the General Agreement on Tariffs and Trade, and the bilateral agreements under the European Recovery (Marshall) Plan. It is a matter of some historical interest that Great Britain tried rather feebly after the Napoleonic Wars to extract commitments of free trade, i.e. free entry of British manufactures, out of the allies which it had subsidized during the wars, but to little avail.[15] The pressure of the United States

[14]Lucy Brown, *The Board of Trade and the Free-Trade Movement, 1830–1842* (Oxford: Clarendon Press, 1958).

[15]John M. Sherwig, *Guineas and Gunpowder: British Foreign Aid in the Wars with France, 1793–1815* (Cambridge, Mass.: Harvard University Press, 1969), pp. 311–13, 330.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

on its allies and defeated enemies was far greater, although in the case of Japan less than completely successful.

As in the case of Britain, U.S. leadership in the free-trade movement can be regarded either as a national effort to produce a world public good—wide markets—or as the achievement of the selfish interest of the abundant factor of production that wanted imports in order better to export. It is perhaps significant in this connection that the United States always insisted that tariff reductions should be reciprocal. In Great Britain, which perhaps believed more fervidly in Hume's law that imports beget exports, unilateral tariff reduction was approved and those who worked for reciprocity were regarded as less than faithful. In the 19th century when the South, with a strong interest in cotton, worked for free trade—on the whole unsuccessfully—U.S. manufacturing was import-competing and protectionist. With the rise of large-scale manufacturing to world dominance in World War I, big American business was on the whole slow to recognize that its interest lay in low tariffs and free trade. For example, Senator Robert Taft from Cincinnati, which exported machine tools throughout the world, remained a staunch protectionist through cultural lag, much as Senator Walter George of Georgia remained a free-trader long after cotton growing had moved to Texas and California and his state was knee-deep in textile plants that would benefit from protection. The manufacturing sector in the United States gradually split on the tariff question: Modern, large-scale industry, multinational in scope and organized in such forward-looking groups as the Committee for Economic Development, favored lowering tariffs, whereas small-scale industry in such lines as textiles and shoes, and belonging to the National Association of Manufacturers, clung to protection. Agriculture remained ambivalent, wanting export markets for grain, cotton, tobacco, oil seeds and the like, but fearful of the competition of Canada in some of those lines and of Australia and Argentina in meat, wool, and butter.[16]

In order to reduce the opposition to the program of lowering tariffs, successive Democratic and Republican administrations sought various concessions: the doctrine of no injury, the escape clause where injury was felt, and peril points below which tariffs could not be reduced—all of which bespeak protectionist ideology. Agreements were signed with foreign exporters to restrict sales to the United States, the International Trade Commission was established, trade adjustment assistance was instituted, and the courts were used to

[16]See Charles P. Kindleberger, "U.S. Foreign Economic Policy, 1776–1976," *Foreign Affairs* 55 (January 1977): 402.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

judge certain complex cases. Concessions were made to interests with congressional clout, but the executive branch kept an ever-watchful eye on Congress to avert another spate of log-rolling such as produced the monstrous Hawley-Smoot tariff of 1930. The process is reminiscent of the myth of Atalanta and the golden apples, when a suitor who would win her if he beat her in a footrace resorted to slowing her down with three golden apples suitably dropped as she overtook him.

Most recently, President Reagan, who believes strongly in free trade, yielded up another golden apple in the form of a tariff on motorcycles to benefit the Harley-Davidson company, the last motorcycle business left in this country, but the tariff is slated to diminish and disappear in five years. The firm has undertaken a commitment to re-equip itself and reduce costs so that it can compete without a tariff at the end of the period. Disappearing tariffs have been recommended by economists in the past as worse than free trade but better than permanent tariff increases. However, many economists have been skeptical, recalling the cynical French aphorism that nothing endures like the provisionary, and doubting that the promised reductions would take place on schedule. In any case, it affords an interesting debate whether Harley-Davidson can shift from Keynesian to Schumpeterian growth and reduce costs so as to be able to compete eye to eye with Honda and Suzuki. It is also a test for the executive branch of government in the next administration: If Harley-Davidson should not make the grade, will that administration let the company go to the wall?

The Danger of Rising Protectionism

Olson's analysis of the gradual encrusting of American political and economic life by coalitions that serve parochial interests instead of the general interest and block one another through the fallacy of composition, suggests a mournful prognosis for tariffs. Aging is leading the United States to shift from Schumpeterian to Keynesian growth. The rise of Europe, Japan, and the Pacific rim countries and the loss of U.S. dominance in world affairs mean that the United States is now less favorably inclined toward free trade for itself. Moreover, even were the United States to cling to free trade itself, it would have less and less success imposing it on others, as it did from 1934 or 1941 to about 1971, and as Britain did in the mid-19th century. The world now appears to run a strong risk of moving into another protectionist era, like that from 1880 to 1930.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Arguments against Free Trade

The classical exceptions to the doctrine of free trade, allowed by such an economist as Adam Smith, have been national defense—the protection of industries that are needed in wartime—and the infant-industry argument. The liberal, mainstream market economist has a ready answer to these arguments. On the national defense argument, he insists first that patriotism is the last refuge of a scoundrel, and many an industry will trot out national defense as a claim for protection with little real justification; and second, that anything a tariff can do, another policy can do better. A subsidy to a necessary defense industry avoids handing out excess profits to inframarginal producers who could keep going without a tariff, and it will allocate the costs of expanding production at the margin in a more equitable way than loading them on the consumer. To the infant-industry argument, the usual reply is that many of these industries turn out to be midgets that never reach full height. And that of course is likely to be true in an economy with Keynesian rather than Schumpeterian growth.

The best example of infant-industry success I know was the U.S. steel industry's response to the McKinley tariff on tinplate. From the 1880s, U.S. demand for tinplate grew by leaps and bounds. Exports of tinplate from Wales to the United States rose more than five times, remarkably without any effect on the technology used by the producers who continued to coat iron sheets in baths of tin solution, sheet by sheet, dipped by hand. The tariff in the 1890 McKinley schedule led to the U.S. production of tinplate, initially with workers from Wales. A new technology was soon developed in which the iron sheets were produced in rolls that were continuously pulled through the tinplating baths. The new technology was resisted by the imported workmen, but those who resisted were sent home. In a few years tinplate imports from Wales dried up, prices fell, and the American industry started to export. This was proof positive that the infant had matured from an import-competing baby to an exporting adult.[17] It is difficult to envisage that tariffs or quotas could stimulate today's U.S. steel industry into innovative activity. Higher prices for steel products would more likely accelerate the rate at which management and capital quit the industry. For instance, when U.S. Steel purchased the Marathon Oil Company at the peak of oil prices, it used so much of its cash and credit that it is unable to refurbish its steel plant with modern equipment to lower costs.

[17]W. E. Minchenton, *The British Tinplate Industry: A History* (Oxford: Clarendon Press, 1957), pp. 63–71.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Despite the success of the tinplate industry, tariffs have not often contributed to national prosperity. I leave aside the Hawley-Smoot tariff of 1930, because the harm to U.S. prosperity came less from that tariff than from the retaliation to it by 30 to 40 other countries. In a Keynesian model without retaliation, a tariff may raise income by diverting spending from foreign to domestic products. If retaliation takes place, however, it may harm national income, depending upon how extensive it is. In 1930, retaliation was very extensive, although how this could have been predicted sufficiently in advance to result in the stock-market crash nine months before the bill was complete and signed, as Jude Wanniski claims,[18] is difficult to see.

In today's world, as U.S. leadership is slipping and the U.S. free-trade example for the world is at best fitful, it is hard to imagine that a substantial tariff increase in this country would not be followed by sizeable retaliation and serious injury to American exports and national income. More interesting perhaps than the Keynesian implications of sizeable tariff increases, however, are the Schumpeterian implications. How might tariff increases affect the drive for modernization and innovation?

To discover the effects of tariffs on modernization and innovation, we can first examine the French Méline tariff of 1890. This tariff was designed to keep American, Australian, Argentine, and Ukrainian wheat out of France. The French had a strong and beneficent motive, to preserve the French family farm and the peasant's way of life. The effort was successful, but at what a cost![19] While the nonfarm sectors of the economy experienced modernization, including both productivity and sociocultural development, the peasant was left behind. It was not until World War II that the French agricultural sector—which was mired in an archaic technology, primitive housing, limited income, shrinking farms, with its proprietors suffering from alcoholism, miserliness, poor health, and limited education—started its transformation. After the war the agricultural sector shrank rapidly, declining from 64 percent of the economically active population in 1896 to 16 percent in 1968. Admittedly lower tariffs did not make much of a contribution to this reorganization in agriculture, which was powered by the strong sociopolitical forces generated by defeat and occupation during the war. The tariff of the 1890s and the quotas on imports of grain from the 1930s to World War II, however, subverted

[18]Jude Wanniski, *The Way the World Works* (New York: Basic Books, 1978).

[19]E. O. Golob, *The Méline Tariff: French Agriculture and Nationalist Economic Policy* (New York: Columbia University Press, 1944); Michel Augé-Laribé, *La Politique agricole de la France de 1880 à 1940* (Paris: Presses universitaires de France, 1950).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

any drive for modernization and innovation that French agriculture may have had.

The classic case of attempted and failed import substitution is that of Argentina, a rich agricultural country that strove after World War I to develop industry with the help of tariffs. It happens that import substitution is a "natural" process in economics, though the use of the word in this field makes me uneasy. As a country gets richer, its demands rise for a variety of goods. Many of these are market-oriented, and when the demand is large enough there is an inevitable move to produce locally for the market rather than import. Sometimes the process is assisted by tariffs, but often it takes place without them. The economy has to be responsive to price incentives and capable of reallocating resources. Such a region as the Pacific Northwest of the United States and such a country as Denmark started out specializing narrowly in a range of products. Bit by bit the growth of income from successful exports led to increases in income, which attracted industry to products that used to be imported. When this import-substitution process is market directed, it takes place without planning. Mistakes are corrected by the failure of inefficient firms and successes are capitalized on by reinvesting profits.

Import substitution in Argentina, on the other hand, was a planned process, using tariffs, and the mistakes were enormous. Moreover, when various hothouse industries wilted, the response was to raise the tariff still further. Goods that could have been bought cheaply with the proceeds of exports were produced expensively at home, while rising costs priced Argentine goods out of their usual export markets. From one of the richest countries in the world, per capita, on a par with Australia and Canada and close to the United States in 1900, Argentina slipped drastically to the middle range of developing countries. One should perhaps be ready to blame sociopolitical factors that prevented the country from developing the Schumpeterian qualities of innovation and successful, undirected import substitution, but the tariff led the country in a direction it was not well equipped to go in.[20]

Is America Slipping into Keynesian Growth?

Is the United States aging, slipping from Schumpeterian into less vigorous Keynesian growth and slowing down in adaptability and capacity to transform because vested interests are choking it? The

[20]See various essays by Arturo O'Connell, Marcello de Paiva Abreu, and others in *Latin America in the 1930s: The Periphery in World Crisis*, ed. Rosemary Thorp and E. V. K. Fitzgerald (London: Macmillan, forthcoming).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

answer seems almost certainly to be yes, although when I said so some years ago Peter Passell said I was indulging in Spenglerian nonsense. Does trade policy have anything to do with the speed with which a country ages, or is it only a result of arteriosclerosis? Much depends in the answer to these questions on political leadership—how farsighted it is—and on political followership, how ready the voters are to throw out administrations and members of Congress who are prepared to allow the economy to undergo some harm in the short run in a gamble that it will do better in the long run. Imports can break up distributional coalitions that take care of themselves at the expense of the commonwealth.

Some years ago, the Nixon, Ford, and Carter administrations had the power, and I think the duty, to say that the steel unions and the steel industry could make any deal on wages they chose, but that the executive branch of government would *never* cut off imports to rescue them from its consequences. Today the Reagan administration is under pressure from Michigan congressmen to extend the restrictions on exports of Japanese automobiles to the United States—export restrictions that the Japanese industry was forced to adopt for a limited period and that expire in the summer of 1984. The American automobile industry was given time to shake down, improve productivity, reduce costs, and zero in on some wage rate that would be in equilibrium in a competitive world; and some firms did. If the period is extended, it will be obvious that the government of the United States is not serious about trying to shift from a Keynesian world to one in which industry has to produce efficiently or go under.

Is the Dollar Overvalued?

An important side issue here is the overvaluation of the dollar. Our foreign economic policy today is something like "the house that Jack built": This is the dog that chased the cat that caught the mouse that ate the cheese, and so on. The cut in taxes combined with the increase in military spending produced a big deficit that increased interest rates and attracted capital from abroad, that bid up the price of the dollar and worsened the competitive position of import-competing industries. To a considerable extent, I have been praising the Reagan administration in this paper for taking a strong stand against tariffs—albeit mitigated by the judicious tossing of golden apples from time to time—and being unfriendly to U.S. businesses and unions for their rent-seeking activities and their piteous pleas for protection. To a degree, however, the faulty macroeconomic policy of the administration has contributed to dollar appreciation and overvaluation—if one believes as I do that purchasing-power parity is not attained

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

under flexible exchange rates at every hour, day, week, month, year. This makes it hard for American labor and American enterprise. I should very much welcome the same ideological approach to free trade in which I believe, and a different ideological, or even better a pragmatic, approach to macroeconomic policy where I do not accept the supply-side nonsense peddled by some of my friends. On the other hand, if one is ready to accept the second best and thinks it is impossible to modify U.S. macroeconomic policy before early 1985, then the question becomes whether one ought to accept a misguided commercial policy to offset our misguided macroeconomic policy. That sort of "second-best" reasoning is widespread historically. The Fordney-Macomber tariff of 1919 was adopted partly in response to exchange depreciation thought to lead to exchange dumping abroad.[21] On the whole, I remain a first-best man: I want an equilibrium exchange rate and a policy of free trade to break up distributional coalitions. I understand the folk saying that the best is the enemy of the good, but I was also brought up on "Good, better, best, never let it rest."

Conclusion

Let me close with another second-best problem. In a paper for a Swiss journal, I suggested that the two cycles in free trade—the British cycle starting in the mid-19th century and the American cycle a century later—might both be followed by eras of protectionism. What then? A new world leader strong in Schumpeterian growth and ready to twist arms to usher in a new era of free trade: Japan? Brazil? the Soviet Union? China? a dark horse? But there is another possible scenario. It could happen that all countries approach freer trade together as the multinational corporation, widely based, makes clear to national governments throughout the world its interest in free trade; an interest based on its being better able to move inputs and outputs around the globe in an efficient way, buying cheap and selling dear. In this view national sovereignty is weakened by cheap transport of goods, people, technology, information, and ideas. Large firms want and politically are able to obtain the freedom to arbitrage widely.[22]

[21]See Charles P. Kindleberger, "Commercial Policy between the Wars," in *The Cambridge Economic History of Europe,* vol. 8, ed. Peter Mathias and Sidney Pollard (Cambridge: Cambridge University Press, forthcoming).

[22]See Charles P. Kindleberger, "Le Libre-échange demain pourrait être imposé par les multinationales," *Le Temps Stratégique* 3 (Winter 1982–83): 95–100.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Political scientists are horrified at the idea that the rise of the multinational corporation and world-wide markets shrink the domain of the sovereign nation, leading to harmonization or homogenization of policies in the fields of money, taxation, business regulation, standards, and, I would add, commerce. Some years ago, Stephen Hymer asked rhetorically which would last the longest: General Motors or France. I was never completely clear what answer he had in mind, but I think it was France. Political scientists such as Stanley Hoffmann and Nicholas Wahl surely feel the same way, but perhaps they forget the demise of earlier political units: the Italian city state, the German principality, the United States county, the French department, and most recently, the serious weakening of state government in this country. I am not unaware, let me add, of the devolution movement in Scotland, separatism in French Canada, and the strains between the Flemings and the Walloons, but I regard the movement toward larger economic units as more compelling.

If free trade is associated with the multinational corporation, believed by some economists and many citizens to be monopolistic, which way should the mainstream liberal economist and citizen go? Many years ago, I recall, some Kansas "farmers" made the argument in congressional testimony that they had been taught to be against monopoly and in favor of free trade. Since free trade in oil was the policy advocated by the major oil companies, who were monopolists, the farmers had reluctantly decided that to be against monopoly meant being in favor of free trade; hence, they wanted a tariff on foreign oil. These farmers may have grown some grain and raised some meat, but I suspect that most of them also had oil derricks in the back forty. The argument was largely one of "little oil" against "big oil," with big oil importing from abroad and lowering the prices that could be charged by the purely domestic industry.

The conflict arises from the fact that the optimum economic area is the world, whereas the optimum social area is much smaller—with the optimum political area somewhat ambiguous and dependent upon whether you are ambitious for power, like Bismarck and De Gaulle, or seek the quiet life like Denmark today. To an economist, one should buy cheap and sell dear as widely as possible, given the constraints of transport costs. For social happiness, one wants to belong to a community where one is known, has a sense of participation and belonging. If there is a clash between the optimum economic area and the optimal social area, then one's choice will depend on the arguments and their weights in one's preference function.

But there is another approach: As a positive rather than a normative question, should one expect the politics or the economics to dominate

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

in the long run? I happen not to be a Marxist but I suspect that in the years ahead, as so often in the past, economic considerations will win out over social and political. If that is what we can expect, there is a strong case for moving toward free trade and competition among countries, and for building world institutions to apply uniform regulation, taxation, and the like in a fair manner and to block arbitrage based on uneconomic differences. We need to work toward harmonized macroeconomic policies for world stability and to correct for market failure in fields such as monopoly, and correct for income distribution where our ethical judgments require it. In the long run, we need to think not only of national prosperity but of international prosperity as well.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

SOME EMPIRICAL RESULTS ON TRADE AND NATIONAL PROSPERITY

Edward Tower

Professor Kindleberger's (1983/84) paper, "International Trade and National Prosperity," touches on some of the most crucial issues facing international policy makers. Among these are the following:

1. What do tariffs and import-substitution strategies do?
2. What is the appropriate role for infant-industry protection?
3. What is the outlook for protectionism in the United States and in the world economy?

I would like to offer a bit of recent empirical evidence on the first two points, and some additional thoughts about the third one.

Tariffs and Import-Substitution Strategies

The ideal set of policies is one in which the most efficient possible combination of instruments is assigned to correct externalities and mitigate inequity in income distribution. As we know this leaves a very limited role for tariffs. Ideally a tariff should be used only when the government's target is to reduce imports or reliance on foreigners, and any other target should be met by a different instrument.

But suppose we are bound to use tariffs because the political process is for some reason too cumbersome to use the ideal set of tools. What would we expect the structure of tariffs to look like? I would expect that in line with conventional rhetoric we would see tariffs protecting jobs, and especially the jobs of the underpaid. This translates into expecting to find that tariffs protect sectors that are relatively intensive in unskilled labor.

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at Duke University, Durham, N.C. 27706. He wishes to thank Martin Bronfenbrenner, David Feldman, Alice Galenson, and Lou Rollinson for their helpful comments.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Let us examine the evidence for the United States. In a recent study Kreinin (1984) examined developments in American motor vehicles and steel. He finds that for 1982 the ratio of labor compensation in motor vehicles to that in all manufactures is 165 percent for the United States but considerably less for American competitors. He concludes that to be competitive with Japan in the motor vehicles industry, U.S. labor compensation would have to decline by 24 percent. Even then it would still remain above the U.S. manufacturing average by 25 percent. Similarly in the United States the ratio of labor compensation in iron and steel to that in all manufactures is 189 percent. In this case American wages would have to decline by 39 percent to restore competitiveness with Japan. But this would still leave labor compensation in this sector at 15 percent above the U.S. manufacturing average. Thus in neither of these sectors can it be said that protection is being used to subsidize relatively downtrodden labor.[1]

On the issue of whether tariffs create jobs in the sense of tending to push the full-employment wage up, Hartigan (1981) provides important material. He finds that the height of the American tariff in 1967 was positively related to the capital intensity of the sector in question, and this is also true of the tariffs levied on American goods by her trading partners.

Along these same lines Hartigan and Tower (1982) used a linear programming model to simulate the impact of tariff changes from the 1967 base on the American income distribution. They found that the U.S. tariff structure tends to protect U.S. capital at the expense of U.S. labor, so that American labor had an interest in unilateral tariff reductions. Moreover, foreign trade barriers, since they are also relatively higher on capital-intensive goods, ended up protecting American labor at the expense of U.S. capital. However, not surprisingly they found that reciprocal tariff elimination would tend to benefit both factors, while tariff wars would hurt labor slightly and benefit American capital. They also found that the group of nonfarm labor that had the most to gain from unilateral reductions in American tariffs and reciprocal tariff reductions was unskilled labor.[2] These simulations rely on a very simple model so the results should be considered little more than suggestive. Nonetheless they certainly

[1]Several studies, however, have found evidence that the extent to which sectors are protected depends negatively on their average wage both for the United States (Fieleke 1976) and Canada (Helleiner 1977).

[2]The results reported here assume that tariff reduction is slow enough that resources have time to reallocate themselves between sectors and that bottlenecks in the supply of capital to particular sectors do not arise.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

do raise doubts about whether U.S. tariffs serve the goal of equalizing the distribution of American income.

Similar results have been discovered for other countries. In a volume summarizing the results of examining trade policy in 12 less-developed countries (LDCs), Krueger (1983, p. 186) finds that, "The extent to which there may have been interaction between inner-oriented trade strategies and factor market distortions, both leading to high capital/output ratios and low rates of increase in the demand for labor, is striking." The reason for this is that LDCs tend to import more capital-intensive goods than they export. Thus import-substitution strategies tend to raise the output of relatively capital-intensive sectors, and by appreciating domestic currencies they make it harder for LDCs to sell their relatively labor-intensive goods abroad. Import substitution, therefore, stimulates sectors with excessively high capital/labor ratios and results in low rates of increase in the demand for labor. The result of all this is an adverse swing in the income distribution away from labor. Krueger (p. 187) concludes that incentives created under an import-substitution regime are "ad hoc, specific and widely varying" and they "do not usually provide the resource allocation gains that can result from uniform, across-the-board incentives."

What is striking to the readers of these studies is how similar all of the stories sound. A special horror story is T. Paul Schultz's (1982) finding that the structure of effective protection in Colombia increased employers' earnings proportionately three times as much as employees' earnings. The 1983 edition of the World Bank's *World Development Report* offers further evidence regarding the failure of tariffs and import-substitution strategies to foster national prosperity. In that study it was found that of a sample of 31 LDCs, those countries with greater distortions had *lower* growth rates, on average, than those countries having relatively fewer distortions. Price distortions were found to explain about one-third of the variation in the growth rates between the high-distortion and low-distortion countries (1983, p. 63).

Another series of studies is reported by Krueger (1983, pp. 42–46). In one of them, Michalopoulous and Jay (1973) essentially fit an aggregate production function to 39 developing countries for the period covering the 1960s. They find that countries that export a larger fraction of their domestic output have higher factor productivity, and that, "The growth rate of GNP and the growth rate of exports are highly correlated with each other" (p. 22). Krueger reports similar findings by Balassa, Krueger, Michaely, and Heller-Porter. A growing body of evidence is therefore available to support the notion that

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

commercial policies, in general, are not in a country's long-run interest—they promote neither equity nor efficiency.

The Appropriate Role for Infant-Industry Protection

We now turn to the second issue I wish to discuss; namely, empirical information on the appropriate role for infant-industry protection. In his study, "Empirical Justification for Infant-Industry Protection," Westphal (1981) found that during the first five to ten years of production in an LDC, it may not be unusual for production costs to fall by as much as 10 percent a year in certain activities. From this observation, he concludes that initially it may be reasonable to grant net effective rates of protection of up to 100 percent. However at the birth of the enterprise the future path of the effective rate of protection should be announced and subsequently followed both to minimize the cost to consumers and to serve as a signal to entrepreneurs to take immediate advantage of the incentives provided.

Westphal asks whether the infant-industry argument should be used for simultaneously protecting a wide range of industries. His answer is a resounding no, because to protect a particular sector is to implicitly tax all the other sectors from which resources must flow. When infant-industry protection runs wild, it ends up offering very little real protection to any sector. Accordingly, he concludes, "protection to infant industries appears to offer a viable means of fostering rapid industrial development, but only if a relatively small number of infant industries is promoted at any one time" (p. 19). Also, limiting the number of protected sectors is particularly important in LDCs where economies of scale are crucial and certain resources are in especially short supply.

Westphal (p. 30) notes an important conclusion from studies of various countries; namely, "exporters enjoy virtually costless access to a tremendous range of technological improvements that are diffused to them through various activities of the buyers of their exports." This is yet another reason why LDCs need to rely on trade. Along similar lines Krueger (1983, p. 51) writes:

> While it is obvious that a firm starting to produce a product previously not manufactured in a country is very likely to sell to the domestic market first . . . experience demonstrates that this is not inevitable. In fact one major way of starting new industries and new product lines . . . has been for firms in developed countries to subcontract with foreign suppliers to fabricate particular parts and components. In some instances the foreign buyer provides technical specifications, technical assistance and even capital.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Thus it seems that the infant-industry argument is at best an argument for subsidizing trade, not for taxing it.

Finally Westphal (p. 33) recognizes that for the infant-industry protection strategy to work, it is very important

> to recognize mistakes and take remedial action quickly, as well as to learn from past mistakes in making future choices. These and many other conditions imply that selective infant industry promotion requires a very high level of competence in its administration. Such competence can be learned, but it is apparent that conditions conducive to its being learned and effectively applied are not present in all countries.

In fact Krueger and Tuncer (1982) found in their study of Turkey that the infant-industry rationale for protection did not apply because there was no tendency for input per unit of output to fall more rapidly in more-protected industries. Thus, to add to the well-known theoretical case against infant-industry protection (see Corden 1974), we have empirical evidence that the policy is likely to work only if it is applied with a precision that does not adequately describe the political process of tariff setting as we know it.

The Outlook for Protectionism in the United States and World Economy

Kindleberger sees U.S. leadership slipping and the U.S. free-trade example unconvincing. He therefore expresses concern about whether the momentum toward freer trade will continue. The average U.S. tariff on all imports is only 3 percent, which is less than it has ever been since America imposed her first tariff in 1789. Yet, America is not a free trader—the United States is party to international agreements on trade in cocoa, coffee, rubber, sugar, and tin. There are also trigger price mechanisms in steel and "voluntary" quotas on autos and textiles. Nevertheless the United States economy in the 1980s is more open than ever before.

Reassuringly we no longer have a major political party that is ideologically committed to protectionism. But as Kindleberger puts it, neither do we have one that is adverse to dropping golden apples. A body of statistical evidence has developed starting with Pincus (1975) that indicates why we cannot think of existing patterns of protectionism as having been designed in order to maximize a social welfare function. Instead the interplay of political forces leads to tariffs that favor those groups with the greatest political power. A second body of statistical evidence also has developed, starting with Little, Scitovsky, and Scott (1970), that emphasizes the importance

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

of trade in the development process. The recent consensus of development economists is much less in favor of import substitution and much more inclined toward reasonably free trade than it was in the 1950s. Finally the World Bank with its structural adjustment loans—which are in effect bribes for freer trade—is taking a stronger pro-market stance than ever before. All these forces should have an impact on making trade freer than it would otherwise be.

References

Corden, W.M. *Trade Policy and Economic Welfare*. New York: Oxford University Press, 1974.

Fieleke, Norman S. "Determinants of the U.S. Tariff Structure for Manufacturing Industries." *Columbia Journal of World Business* (Winter 1976): 98–104.

Hartigan, James C. "Does Factor Content Determine Protection?" *Southern Economic Journal* 48 (July 1981): 144–48.

Hartigan, James C., and Tower, Edward. "Trade Policy and the American Income Distribution." *Review of Economics and Statistics* 72 (May 1982): 261–70.

Helleiner, G.K. "The Political Economy of Canada's Tariff Structure: An Alternative Model." *Canadian Journal of Economics* 10 (May 1977): 318–26.

Kindleberger, Charles P. "International Trade and National Prosperity." *Cato Journal* 3 (Winter 1983/84): 623–37.

Kreinin, Mordechai E. "Wage Competitiveness in the U.S. Auto and Steel Industries." *Contemporary Policy Issues* 4 (January 1984): 39–50.

Krueger, Anne O., and Tuncer, Baran. "An Empirical Test of the Infant Industry Argument." *American Economic Review* 75 (December 1982): 1142–52.

Krueger, Anne O. *Trade and Employment in Developing Countries*. Vol. 3: *Synthesis and Conclusions*. Chicago:University of Chicago Press, 1983.

Little, Ian; Scitovsky, Tibor; and Scott, Maurice. *Industry and Trade in Some Developing Countries*. London:Oxford University Press, 1970.

Michalopoulous, Constantine, and Jay, Keith. "Growth of Exports and Income in the Developing World: A Neoclassical View." AID Discussion Paper No. 28, Agency for International Development, Washington, D.C., 1973.

Pincus, Jonathan. "Pressure Groups and the Pattern of Tariffs." *Journal of Political Economy* 83 (August 1975): 757–78.

Schultz, T. Paul. "Effective Protection and the Distribution of Personal Income by Sector in Colombia." In *Trade and Employment in Developing Countries*. Vol. 2: *Factor Supply and Substitution*, pp. 83–148. Edited by Anne O. Krueger. Chicago:University of Chicago Press, 1982.

Westphal, Larry E. "Empirical Justification for Infant Industry Protection." World Bank Working Paper No. 445, Washington, D.C., March 1981.

World Bank. *World Development Report 1983*. New York: Oxford University Press, 1983.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

REALISM AND FREE-TRADE POLICY

Leland B. Yeager and David G. Tuerck

Realism versus Fantasy

Nowadays the press and the hearing rooms of Congress are full of remarks to the effect that free trade is unreal, a fantasy, a myth, "a Utopian dream." Its "Utopian-like promise" has been "eroded by the realities of the marketplace." No country does or will practice it. The classroom, where free-trade arguments flourish, is not the real world. Times have changed. The standard old arguments no longer apply, if they ever did. Enough of "the free-trade fallacy"; enough of "free-market rhetoric." The time has come for "a trade policy founded on realism," one "based on the world as it is—not as we might like it to be." Government must play a role: "Don't call it protectionism but realism." Especially nowadays, advocating free trade is seen as pointless and unreal.[1]

If our readers want a prediction from us—strictly a prediction, not an analysis or a recommendation—first we will emphasize that we are not experts in foretelling the future in general or political developments in particular. Then we will recognize that we do not expect to see, in our lifetimes, actual, literal free trade adopted in the United States or any other major country. In that restricted sense, we agree that free trade is unreal.

Adam Smith himself conceded as much in 1776:

> To expect, indeed, that the freedom of trade should ever be entirely restored in Great Britain, is as absurd as to expect that an Oceana or Utopia should ever be established in it.
>
> [1937, p. 437]

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

Leland B. Yeager is Paul Goodloe McIntire Professor of Economics at the University of Virginia, Charlottesville, Va. 22901, and David Tuerck is an Associate Professor of Economics at Suffolk University, Boston, Mass. 02108.

[1]Extensive citations would be tedious. However, the particular words in quotation marks come from the following sources: Raymond A. Hay, chairman of LTV Corporation, in LTV (1983b, p. 25); Kuttner (1983); Garten (1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Smith based his prediction on political realities:

> Not only the prejudices of the public, but what is much more unconquerable, the private interests of many individuals irresistibly oppose it. [Domestic manufacturers defend their "monopoly" of the home market.] This monopoly has so much increased the number of some particular tribes of them, that . . . they have become formidable to the government, and upon many occasions intimidate the legislature. The member of parliament who supports every proposal for strengthening this monopoly, is sure to acquire not only the reputation of understanding trade, but great popularity and influence with an order of men whose numbers and wealth render them of great importance. If he opposes them, on the contrary, and still more if he has authority enough to be able to thwart them, neither the most acknowledged probity, nor the highest rank, nor the greatest public services, can protect him from the most infamous abuse and detraction, from personal insults, nor sometimes from real danger, arising from the insolent outrage of furious and disappointed monopolists.
>
> [1937, pp. 437–38]

Smith also noted the role of sophistries and prejudices:

> In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind.
>
> [1937, p. 461]

What is the force of predictions like Smith's and ours? They could prove wrong. Smith was wrong, or nearly wrong: Free trade was almost completely achieved in Britain some 70 years after he was writing. But even if the pessimistic predictions are right—"realistic"—they in no way invalidate the standard economic analysis of gains from trade and losses from restriction. The question for economists is not whether to predict free trade but whether to recommend it. Their job is not to be realistic but to get the analysis straight.

Of course, "realism" has different meanings. When it means trying to understand correctly how events and conditions are interrelated in the real world and what consequences would flow from various policy measures, we applaud it; we hope that we too are realists. Such realism, also sometimes called "pragmatism," implies a willingness to learn from experience, to modify one's theories in its light, and to abandon or alter policies based on theories that have proved wrong. Often, though, the widely admired realism or pragmatism means—to use blunt language—operating by the seat of one's pants,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

without benefit of any theories recognized as such, but only on the basis of tacit, unarticulated, unexamined theories.

The realism we particularly meant to scorn in the paragraph before last is political realism—the practice of compromising between giving the policy advice one really thinks best and giving the advice one thinks stands the best chance of commanding the necessary votes. It means trying to straddle the roles of professional economist and amateur politician. Besides being suspect in other ways, such realism is immoral. It involves actively or passively concealing the truth as one sees it; it compromises scientific integrity. By his political trimming, the "realist" reinforces a state of opinion in which the policies he truly but secretly thinks best appear all the more extreme and unrealistic. By so doing, he unjustly casts the relatively few advisors who do speak forthrightly all the more completely into the role of ivory-tower dreamers. He wins plaudits for realism at the expense of those who are more honest; he seizes special privilege for himself.

We do not condemn an advisor's answering a question about what policy he would consider second best if his first-best policy were explicitly ruled out, even perhaps on political grounds. He should avoid, however, appearing to recommend a lesser evil as a positive good. This obligation follows from the obligation to be clear and not take refuge in deceptive ambiguity. We also do not blame politicians for making tactical compromises; their job is different from the job of those who offer themselves as expert advisors.

In earlier work, we presented examples of economists and other witnesses before congressional committees who, apparently out of political realism, shrank from forthrightly recommending actual free trade.[2] Nowadays, it seems, political realism is being overshadowed by a different brand. (Our impression could be wrong; and in any case, we do not want to identify professional economists as the main culprits.) According to this "new realism," as we might call it, free trade not only lacks the votes but is objectively impossible and undesirable, and the very advocacy of it is morally suspect.

Phraseology such as we quoted in our opening paragraph characterizes this position. According to a former State Department official (Garten 1983), "the first step" toward a coherent trade policy

> is to drop the illusion that America is Mr. Clean in a hostile world of protectionists and cheaters. Others are not pure, but neither are

[2]Yeager and Tuerck (1966, pp. 282–85). (Much of the material cited in this and later references to that book also appears in our revised edition, 1976.) We follow the analysis of Philbrook (1953). Hutt (1971) develops a similar analysis.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> we, as we have demonstrated by our restrictions on imports of steel, autos, textiles and dairy products. Washington must also drop the hope that the free market will again become the norm.

Another new realist (Kuttner 1983, p. 17) describes the General Agreement on Tariffs and Trade as something that the United States invented in its own image and then commended to the rest of the world "the way the biggest kid on the block calls for a fair fight." Now the United States compounds the failure of GATT to eliminate nontariff barriers by violating its own "saintly standards" with export-promotion corporations, farm subsidies, Pentagon research, and the rest.

According to a Harvard professor of public policy whose writings have contributed to the current vogue for some sort of "industrial policy" (Reich 1983, pp. 774–75),

> the classic principle of free trade no longer offers any practical or politically compelling alternative to protectionism. The recent collapse of free-trade ideology into retaliatory protectionism attests to the bankruptcy of that ideal in the present international economy. The sources of this breakdown lie deeper than the current worldwide recession and an over-valued dollar, both of which obviously imperil political assent to an open trading system. The free-trade ideal has been eroding—both within the United States and among America's trading partners—for over a decade. The erosion originates in the profound structural changes that have been reshaping the world's economy.

Other observers (including Krauss 1978) have also identified a "new protectionism." That term refers not only to the resurgent protectionist clamor but also to increasing resort to measures other than the old-fashioned and relatively innocuous—we stress "relatively"—tariff on imports. These nontariff measures include import quotas, export and production subsidies, preferential trading arrangements, health and safety regulations and administrative complexities discriminating against imported goods, government procurement practices, "voluntary" export restraints and "orderly marketing agreements" imposed on foreign suppliers, and "adjustment assistance" programs that in some respects discourage rather than ease adjustment by domestic producers to changes in market opportunities posed in part by foreign competition. (On the last-mentioned phenomenon, see Dorn 1982.)

Old Complaints with New Decoration

Why has the free-trade ideology, formerly respectable, fallen to such low esteem? The new realists answer, in part, that when Adam

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Smith and David Ricardo created that ideology, they were thinking about a "static" world in which the pattern of comparative advantage depended on "natural endowments" (Reich 1983, pp. 777–80). Actually, Smith and Ricardo were writing in times of great change, in the midst of an industrial revolution to which their own policy ideas were conducive. Furthermore, Smith knew that physical nature alone does not dictate a country's pattern of productive advantages, yet acquired advantages can be genuine. "It is an acquired advantage only, which one artificer has over his neighbour, who exercises another trade; and yet they both find it more advantageous to buy of one another, than to make what does not belong to their particular trades" (1937, p. 426).

But let this reply pass. Relatively free trade worked well for the United States in the early years after World War II, the realists continue; American producers could expand their activities without serious challenge from abroad. Now things are quite different. The rest of the world would not long tolerate a situation so favorable to American interests and to the survival of classical economics. The Japanese struck first with automobiles and consumer electronics and now threaten American hegemony in random-access memory chips and computers. Under the old assumptions, countries like Japan and Taiwan would have gone on indefinitely producing clothing and toys, but now they export CB transceivers and microwave ovens. The Germans produce specialty steel and the French produce nuclear-powered generators, all thanks to government intervention.

In passing, we note how common it is to decorate such arguments with references to particular high-tech products and particular organizations and programs; references to 64K and 256K chips and Japan's Ministry of International Trade and Industry are standard fare. Such decoration serves to convey the impression that the author possesses up-to-date and detailed knowledge of facts about technology, industry, and government, as if such facts were relevant to choosing even broad lines of economic policy; he is no mere ivory-tower dreamer.

Never mind. The upshot of the argument is that massive structural changes in the world economy have robbed the law of comparative advantage of the static framework that gave it legitimacy. Comparative advantage has become "an ever-changing product of social organization and choice." Whereas the United States was once rich in capital and other parts of the world in unskilled labor, complicated production processes and the machines that use them now flow easily into countries where the work force, suitably prepared by industry or government, turns out goods in competition with American producers. "In a very real and immediate way, a nation *chooses* its

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

comparative advantage. The flexibility of its institutions and the adaptability of its work force govern the scope of choice. Decisions on human-capital development define a nation's competitive strategy" (Reich 1983, pp. 777–78).

In the absence of widespread government intervention, as supposedly practiced most notably by the Japanese, international trade patterns would conform to market-determined prices reflecting differences in countries' natural advantages. In today's real world, governments pursue industrial policies that distort prices and trade patterns. In the words of Kuttner (1983, p. 16), the classical theory of free trade "doesn't fit a world of learning curves, economies of scale, and floating exchange rates. And it certainly doesn't deal with the fact that much 'comparative advantage' today is created not by markets but by government action."

One article taking this general line—things are different; let's be realistic—is particularly noteworthy for being written by a conservative who is president of the United States Industrial Council, an organization supposedly dedicated to winning support for a market economy and a free society. According to Anthony Harrigan, "the United States is the target of *economic* warfare." "[T]he trade situation is a battle" whose "outcome will determine the standard of living and the national security of the American people." Foreign governments subsidize companies selling in the United States and even own some of them. Such companies may be less concerned with profit than with market share. "It is shocking [and humiliating, the implication runs] that we should be a resource base for Japan, supplying grain, soybeans, rice, and timber, and, in return, getting the manufactured goods we once produced in vast quantity and superlative quantity." America has become "a hewer of wood and a drawer of water" for foreigners. The Japanese are insular and cliquish and do not bear their fair share of defense costs. Their government controls and plans almost every phase of the Japanese economy—so Harrigan thinks.

But, he continues, "the Japanese aren't the only ones who treat trade as an offensive weapon. Around the world, barriers are put up to keep out American products, while imports come into the U.S. in a flood that threatens to swamp our industries." By the turn of the century, Harrigan says (quoting a Berkeley professor of political science), the combined industrial power of several Asian nations will exceed that of the United States or Western Europe. The upshot is that we desperately need "protection against foreign governments." We should "insist on measures to promote genuine free trade—fair

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

trade—in international circles" (Harrigan 1983, followed immediately by Walter Olson's appropriate commentary).

Well, let's see. If foreign governments give their companies advantages allowing them to compete cheaply in the American market, so what? Just how does it matter why imported goods are as cheap as they are? We consider this central question in the next section of this paper. What about government ownership of some foreign companies? Well, the burden of socialism falls on the foreigners, not on us Americans. If political and other factors make for inefficiency, requiring subsidies and swelling the deficits to be covered by the taxpayers, or if private enterprise is restricted from competing with those companies in their home countries, it is primarily the foreigners who suffer. Operating within the United States, even socialized foreign companies are subject to our laws: They cannot compel customers to do business with them; they cannot forcibly exclude competitors. Since the disadvantages of socialism are concentrated on the countries practicing it, pointing to it with alarm, or, more broadly, pointing to government control and planning, serves more as a debating point than as a substantive point. It stirs up emotions against tricky and unfair foreigners.

It is odd of Harrigan, as Walter Olson (1983) notes, to think we are "cruelly dependent" on foreigners, and not vice versa, when we rely on them for things like tape decks and towels, while they rely on us for food and raw materials.

Harrigan's point about the growth of wealth and productive capacity abroad would be relevant if the foreign countries were our actual adversaries and not just metaphorical adversaries in a supposed contest of economic performance. Trade with Soviet Russia presumably benefits both the Russians and us economically; but if it benefits them *more,* as it almost surely does, then it weakens our position in an actual struggle. What weakens us is not the goods we receive from them but the strength they derive from Western goods and technology and credits. This consideration, along with others, deserves weight in our trade policy; and if the relevant arguments, including strategic and moral ones, should preponderate over the standard argument about mutually beneficial trade, we would be prepared to make an exception in this regard to our advocacy of outright free trade. Our exception about trade with Russia should not be seen, however, as an exception to our case for free markets and free people. As for our allies' obligation to bear a bigger share of the defense burden, Harrigan may well be right—but on a side issue, not on the trade issue.

The complaints already reviewed point to supposed "unfairness" as a major issue. Kenneth Schwartz, vice president of Opinion Research Corporation, reports (in LTV 1983b, p. 37):

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> There's an increase in the support for protectionism, particularly with the unemployment situation, the more that people feel . . . that the country is falling behind, worldwide. . . . people are concerned about unfairness in the trade situation. They're concerned about the Japanese—they buy the Japanese products, but they're concerned about the Japanese being reciprocal.

Professor Robert Baldwin (in Amacher et al. 1979, p. 236) reports a common reaction to a familiar free-trade argument:

> If foreign governments want to use their own taxpayers' money to provide us with goods at lower prices than we can provide for ourselves, then we should welcome the addition to our living standards. . . .
>
> Members of the business and labor communities listen to such arguments with incredulity and promptly write off any economist making them as hopelessly unrealistic. To them it is abundantly clear that such government actions are grossly "unfair."

Senator Huddleston of Kentucky (in LTV 1983b, p. 122) says that we are for "fair trade and free trade, but we want to play on the same field, and we want our manufacturers to have the same opportunity to sell as we give to other manufacturers in foreign countries." Referring to the motivation behind one of the trade bills pending in Congress, Representative Frenzel of Minnesota (who happens to be relatively sympathetic to liberal trade policies) spoke of an urge "to level out the playing field, as if to state that we in America are always working uphill and everybody else is working downhill toward us. . . . I think our playing fields on the whole are not completely level, but the law that exists today can make them so" (in LTV 1983b, pp. 98, 101). William Brock, the chief U.S. trade negotiator, complains, "We still live in a world where many don't believe in playing by the rules. Pursuing freer trade will require that we play tough aggressive ball" (quoted in LTV 1983a).

Complaints about unfair trade practices often appeal to gauzy ethical intuitions by drawing analogies with games. They suggest that something like cheating at cards or sabotaging a rival driver's car is going on. "Fair competition" is an end in its own right in a game or a race—true enough—but not in trade. The objective of trade is to get goods on advantageous terms. To interfere with trade because foreigners offer us exceptionally advantageous terms is to reject the very principle of gain from trade.

Notions of "reciprocity" enter the discussion. The word used to bring reciprocal trade agreements to mind: You lower your trade barriers, and we'll lower ours. Now it is increasingly taking on the meaning of retaliation. The Canadian ambassador to the United States,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Allan E. Gottlieb detects a "no-more-Mr.-Nice-Guy syndrome" in this country. As he sees it, the demand for reciprocity has come to mean: "If you won't open up your markets to us, we'll close down our markets to you." Unfortunately, "reciprocity" is a seductive term, seeming to imply "fairness, equal market access among trading partners" (in LTV 1983b, pp. 12–14).[3]

Unsurprisingly, calls for fairness and reciprocity allude to Japanese conditions. In Japan, American exporters encounter not only relatively forthright trade barriers but also the complexities of wholesale and retail distribution systems and even, supposedly, a national ethos that discourages the purchase of foreign goods. How arrogant of foreigners to expect rights in the American market that they withhold from Americans in their markets!

Lester Thurow (in Miller 1983, p. 41) would

> no longer tolerate the agricultural protection that Japan and the Common Market give their farmers. If they will not open their agricultural markets (one of our major comparative advantages), then we should close them off from some of their major comparative advantages in our markets. We simply cannot afford to continue our current generosity in agricultural trade.

Adam Smith (1937, p. 460) knew of and commented on reciprocal trade policies:

> The sneaking arts of underling tradesmen are thus erected into political maxims for the conduct of a great empire; for it is the most underling tradesmen only who make it a rule to employ chiefly their own customers. A great trader purchases his goods always where they are cheapest and best, without regard to any little interest of this kind.

Of course foreigners practice the not-so-new "new protectionism" already mentioned. Their political systems respond to the same sorts of pressures as ours does. This is regrettable. Foreign trade barriers deprive foreigners and us alike of potential gains from trade, just as our own barriers do. We would benefit from dismantling ours; we would gain more if foreigners dismantled theirs too.

Meanwhile, the foreign trade barriers and other economic interventions are facts of reality, much like facts of nature, technology, institutions, and consumer tastes. Their existence, and changes in them, have to be taken into account and coped with somehow or other. We submit that no better method is available than the market mechanism, whose price signals reflect realities (unpleasant and

[3]On the stretched meaning of the word "reciprocity," also see Joseph Sisco's remarks (in LTV 1983b, p. 6).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

pleasant ones alike) and bring appropriate knowledge and incentives to bear on the decentralized decisions of millions of persons. Experience in trying to cope with the oil embargo of 1973–74 by legislation and administrative orders hardly recommends that alternative to the price system.

What can we do about foreign trade barriers? As Lord Beveridge once quipped (1932, p. 110), that other countries have bad harbors is no reason for us to sink rocks around our own coasts. "We're in the same boat with our trading partners," said President Reagan (quoted in Evans and Novak 1983, p. 101). "If one partner shoots a hole in the boat, does it make sense for the other one to shoot another hole in the boat?" If my neighbor disturbs me with loud, drunken parties, can I remedy the situation by throwing loud, drunken parties of my own?

Conceivably, we Americans might use our trade barriers as a bargaining weapon to prod foreigners to join us in adopting free trade after all. Embarking on that course—if it would work—would imply acceptance, not rejection, of the free-trade argument. We therefore do not reject the bargaining approach on principle. We do fear, though, that that approach, instead of working, would boomerang into still worse protectionism at home and abroad. The considerations necessary for forming a judgment go well beyond economic analysis, and we do not care to repeat here why we have tentatively concluded in favor of *unilateral* American adoption of free trade (Yeager and Tuerck 1966, chap. 16).

An old and sweeping complaint of protectionists is that the case for free trade presupposes certain ideal conditions—classroom conditions—not found in the real world. One representative of organized labor (Nat Weinberg in Amacher et al. 1979, p. 307) insists on examining trade policy issues

> not on the basis of abstract and questionable theories but in terms of their practical consequences for people.
>
> The fact is that the assumptions underlying comparative advantage are ridiculously irrelevant to the realities of the modern world. Among those assumptions are: (1) full employment which, particularly in the United States and the economically underdeveloped countries, has been more notable for its absence than for its presence; (2) immobility of the factors of production which, as applied to capital, is utter nonsense in the era of the transnational corporation; (3) competition which is belied by the prevalence of oligopoly and cartels; and (4)—implicit in Ricardo's original statement of the theory—international equality of wages. As if all that were not enough, there are the further departures from the theory resulting from tax havens, dirty floats, tax deferrals, transfer price manipulations, and

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> the vast array of concessions and subsidies that transnational corporations extort from host countries.

Leonard Silk of the *New York Times* (1978, pp. 25–26) even asserts that the entire case for a free-market economy rests on unrealistic assumptions:

> The grand, underlying theme of Adam Smith's *Wealth of Nations* was his belief that the pursuit of individual self-interest and the attainment of the social welfare are harmonious. . . .
>
> . . . [Paul] Samuelson showed that Smith's basic tenet—the core of the classical and contemporary case for free enterprise and against state interference—rests on the assumption of *perfect competition*. . . . The entire libertarian case for laissez-faire seemed (and still seems) to Samuelson to rest on feeble assumptions.

The quoted remarks illustrate a standard debating ploy: to assert that the opponent's case rests on certain assumptions, to deny that those assumptions are valid, to allude to several of the innumerable miscellaneous facts of reality that the opponent's discussion (like any discussion of finite length) did not mention, and then to carry on as if the opponent's case had collapsed.

Valid as it is, the principle of comparative advantage is not the core of the free-trade case. The central idea, rather, is the commonsensical one that obtaining useful goods cheaply is better than obtaining them expensively. Trade, like technological progress, reduces the cost of goods in terms of labor and other scarce resources; it raises the standard of living obtainable from available resources. The role of the principle of comparative advantage is to show how a leading objection to this analysis is fallacious *even if* its central assumption is granted for the sake of argument. (See Yeager and Tuerck 1966, esp. pp. 39–42, 136–38.)

The case for free trade is a particular application of the general case for the unfettered market economy or price system. That case does not rest on any contention that free trade at home and among countries results in Pareto optimality (to use a favorite concept of the technical literature).[4] It rests, rather, on comparison with any other way of organizing economic activity. The market system leaves people free and motivated to seek and reap gains from production, innovation, and exchange. It puts inevitably dispersed knowledge to use through decentralized decision making, while prices convey signals about circumstances beyond the decision makers' immediate ken. Market prices, while not exactly "right" in the sense of the abstract

[4]The concept of Pareto optimality, however useful for other purposes, cannot sensibly serve as a policy criterion; see Yeager (1978).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

theory of general equilibrium, do come under competitive pressures tending to adjust them in the right direction.[5] The price system also has the great merit of tending to keep down the power of man over man by separating political and economic power.

The protectionist assertion that the free-trade case rests on unrealistic theories and assumptions boomerangs, especially when decorated with remarks about a dynamic world. Even more unrealistic is the concept of an ideal pattern of corrective interventions, always kept ideally adjusted to changing conditions. Any moderately competent theorist can dredge up arguments, intellectually respectable in abstract principle, for almost any intervention plausible enough to enjoy political support. This very possibility of concocting superficially plausible cases for all sorts of specific interventions—notably externality cases, as we explain later—warns against overenthusiasm for them. Each intervention has repercussions that change what other interventions would be ideal. Adapting each one not only to the "imperfections" of a free economy but also to the distortions caused by all the other interventions is hardly practical.

Although sophisticated protectionists may occasionally try to score points by contrasting free markets in the real world with the conditions required for Pareto optimality, the charge that the case for free trade rests on hopelessly unrealistic theories and assumptions is more typically congruent with a sweeping contempt for economic theory. (Recall the standard scornful remarks about classrooms and textbooks.) This contempt is understandable: If one cannot answer an unwelcome argument, one disparages it in broad, vague terms. In rejecting economic theory, protectionists are rejecting attention to the possibly far-reaching and unwanted repercussions of the particular government interventions that they call for; they are rejecting attention to general economic interdependence. They are refusing to see an economic system as just that—as a *system* of intertwining and mutually conditioning activities operating in conformity with economic laws. Instead, they tend to view an economic system as a collection of separate activities amenable to improvement by such

[5]See Allais (1971). Allais warns against infatuation with formalistic general-equilibrium theories presupposing general convexity of choice and production fields, the prodigious services of the Walrasian auctioneer, and all the rest. He recommends a more realistic view of a world of multiple markets on which transactions take place at prices specific to them (not necessarily general-equilibrium prices). In this real world, people engage in a decentralized search for surpluses; that is, for gains from trade and transformation.

For a more broadly phrased case for the free-market economy, see the many writings of F. A. Hayek, for example, *The Mirage of Social Justice* (1978, chap. 10).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

separate government interventions as their untutored pragmatism recommends.

No one, not even self-styled pragmatists, can operate without theory. Theory—at least some notion of how things hang together—is essential to organizing one's perceptions of reality and to forming expectations of, for example, the results of a recommended intervention. Anyone presenting a fact or figure in a policy argument has some notion, presumably, of how it fits in, of what difference it makes; and that is his theory. The true contrast is not between academics who theorize and practical men who stick to the facts but between people who theorize with the advantage of knowing what they are doing and people who theorize without realizing it. Unarticulated, unexamined theory is the worst kind.

Cheap Foreign Goods

We do not want to repeat here the standard free-trade case and the standard demolition of standard protectionist arguments. We are getting rather bored with the whole exercise—and frustrated by the protectionists' inattention. (However, we do not disparage such repetition by others. We welcome experiments in restating the message in fresh and compelling ways; "for only by varied iteration can alien conceptions be forced on reluctant minds" [Spencer 1978, vol. 1, p. 34].) Here, instead, we want to insist on a single vital question.

How does it matter to us just why foreigners offer us their goods as cheaply as they do? How does it matter why Ruritanian widgets delivered in the United States are as cheap as they are? Perhaps Ruritania's climate and resources are ideal for widget production. Perhaps the Ruritanian widget industry enjoys the special skills that its workers have developed over generations. Perhaps a mass market in Ruritania affords scope for economies of large-scale production. Perhaps Ruritanian manufacturers are selling below current cost in an effort to expand sales and production, take advantage of the learning curve, and get costs down. Perhaps widgets grow wild on bushes and can be harvested at slight cost. Perhaps, on the other hand, Ruritanian employers scandalously underpay their workers; or perhaps the Ruritanian government subsidizes the dumping of widgets in the United States at prices below the home price or the cost of production. Perhaps the Ruritanian government, using all manner of policy instruments, has been deliberately fostering a large and efficient widget industry.

How does the effect of widget imports on the American economy depend on the particular reason for their cheapness? If cheap foreign

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

goods either benefit or harm us Americans, how could the nature and degree of that benefit or harm hinge on something more recondite than the prices of the goods themselves? If a detailed investigation of costs and prices abroad would be necessary to determine whether dumping is taking place (in either of the senses mentioned), does that very necessity not indicate that the reason why the imports are so cheap cannot be inferred from effects observable in the United States?

Yet, to mention a recent example, the U.S. Department of Commerce has been snooping around a firm's premises and records in France to determine whether that firm has been dumping industrial nitrocellulose in the United States. The investigators felt they had to consider such questions as whether it is appropriate to use straight-line or accelerated depreciation, whether costs should include research and development expenses incurred for other product lines also, and whether the seller really does offer discounts to French customers equivalent to those offered to American customers. The investigators concluded that dumping had indeed occurred: The French market value of the nitrocellulose exceeded the price in the United States by an estimated weighted-average margin of 1.38 percent (U.S. Department of Commerce 1983). What a remarkably precise answer to so inherently vague a question! It is as if psychological researchers had concluded that Icelanders are on average 5.16 percent happier than Patagonians.

We do not deny that some answers might be given to the questions we have raised, but we do challenge protectionists to face those questions squarely. Conceivably, the reason why foreign goods are cheap might give a clue to how *dependable* their cheapness is. An atrocity case is sometimes imagined: The foreigners dump their goods to destroy the American industry, then switch to exploiting us by monopolistically high prices. This case is seldom if ever documented, for such tricks would scarcely work. One or two other cases, almost mere theoretical curiosities, might also provide answers to our questions (see Yeager and Tuerck 1966, pp. 149–54, 198–99, including the long footnote on p. 199). The point to stress, however, is that foreign goods available to us at low prices offer us an opportunity for gain, whether their cheapness traces to persistent dumping or any other circumstance.

Complaints about the artificial cheapness of imports, then, are practically always a red herring. They gain political effectiveness anyway by appealing to loose ethical intuitions. Yet as we have already seen, the notion of "unfairness," as if the foreigners were cheating in a game, simply does not apply in this context.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

We sympathize with American workers displaced by the competition of cheap imports. Their displacement is what it is, however, regardless of just why the imports are cheap. The reason for the cheapness affects only the opportunity to deploy arguments that appeal less to fact and logic than to emotion, xenophobia, and garbled notions of morality. Apart from such objectively irrelevant rhetoric and policies possibly triggered by it, American workers are no better or worse off if displaced by subsidized imports than if displaced by imports actually produced at low cost, displaced by competition at home, displaced by new and better products, or displaced by changes in the tastes of consumers.

An economy with rising standards of living, improving job opportunities, and freedom for consumers and workers—and, yes, for entrepreneurs and investors—to explore and cultivate the opportunities open to them is bound to be a world of change. Change always harms some people. In response to change, the choice lies between, on the one hand, institutions and policies that attempt either to block change or provide shelters against its impact and, on the other hand, institutions and policies that facilitate adjusting to change and taking advantage of it. The protectionist road leads to stagnation. Furthermore, efforts to protect particular sources or types of income throw all the more burden of change on the ones left unprotected; for not all can be protected, short of literal totalitarianism. The protectionist approach impairs the economy's coping mechanisms, including the signals and incentives conveyed by prices responsive to changing conditions. Protectionist policies also impair the growth that itself eases coping with change (for the relative or absolute shrinkage of particular job opportunities is more bearable in a growing economy). (These points form the main theme of Krauss 1978.)

The other road is that of a free-market economy, with flexible prices tending to adjust to keep markets cleared in the face of changed conditions and at the same time conveying appropriate signals and incentives. (To say this is not to express belief in complete price flexibility and equilibrium always; the real world—let's face it—does not and cannot have all imaginable perfections.) Business firms and workers challenged by new domestic or foreign competition or by adverse changes in consumers' tastes then have the option of slowing the loss of customers and jobs by accepting reduced prices and wages while seeking more attractive opportunities for adjustment; they ordinarily need not suffer instant total displacement. In a free economy, workers, businessmen, and investors can sort themselves into more and less risky lines of endeavor according to their own diverse tastes for chances of gain balanced against risks of unemployment or

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

loss. In a free economy, entrepreneurs will discover ways of making mutually advantageous offers to displaced workers and owners of displaced productive assets. Demands for economic security will be met by insurance schemes and in other ways. We do not rule out a role for government in providing economic security, but we do caution that its measures should not make pointless distinctions between sources of displacement, should not discourage adjustment instead of easing it, and should not impair the price mechanism and rigidify the economy.

We know that the United States does not now have a fully free economy. (Analysis of an economy conforming to the textbook chapters on pure and perfect competition is valid and useful for some purposes, but not for providing a benchmark against which to assess the kind of free economy that does or could exist in the real world.) We now have a market economy distorted and impaired by all sorts of protectionist interventions. We refer to protectionism in the broad sense—to measures intended to provide shelter against all sorts of competition and change and not merely against the competition of imported goods. Besides itself undertaking innumerable protectionist actions, the government also tolerates certain notorious private coercive interferences with voluntary transactions.

Yet today's new realists and new protectionists recommend, in effect, more of the same. In particular, they want more government interference with international transactions. The more sophisticated among them, to be sure, do recognize the sorry record of government intervention—piecemeal, working at cross-purposes, distorted by political considerations, and generally counterproductive. Ironically, this state of affairs provides an argument of sorts for an industrial policy, to use the phrase now in vogue. Interventions will be rationalized, systematized, and made to serve coherent goals. The record has been sorry so far, mais nous allons changer tout cela.

The Illusion of Ideal Intervention

The Economics of Interventionism

A free-market economy would not enjoy all imaginable perfections. Some discrepancies between the marginal social benefits and marginal social costs of particular goods would always exist. Pricing to exploit monopoly positions (typically only temporary positions) is one reason. Another reason, a wide-ranging one, is "externalities." Externalities are damages and benefits that some people inflict or confer on others, who do not, however, receive or pay compensation. A standard example is the damage that a factory does by spewing

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

smoke from its chimneys or dumping wastes into a river. On the benefit side, an apple grower may unintentionally provide nectar for his neighbor's bees, or a company's research for its own products may make new knowledge available free for others. In such cases, market prices are inaccurate signals. A person deciding on an activity that incidentally harms others will probably carry it "too far" (to the point where additions to the losses of all affected persons outweigh additions to their benefits), since he does not bear all of the true costs. A person deciding on an activity that incidentally benefits others will probably cut it "too short" (at a point where additions to the benefits of all affected persons would still outweigh additions to total costs), since not all the benefits accrue to him. Market prices misrepresent the true terms of choice between complete packages of net satisfactions. Externalities trace to failure fully to apply the logic of marketable property rights; but its full application may be impossible under the circumstances, or prohibitively expensive.

Most interventionist arguments, to the extent that they have any analytical content at all and are not mere naked demands for special favor at the expense of other people, may be interpreted as externality arguments. Suppose a particular industry is desired in the United States partly for its own sake and not merely for the products that it currently provides. It might be providing a "service of availability," standing ready for conversion to military production in wartime; or it might be providing new knowledge or experience or worker training beneficial to other sectors of the economy that it nevertheless cannot collect payment for. Such an industry might be a plausible candidate for protection against import competition, for a subsidy, or for other governmental favor.

Arguments like that can be valid in the abstract, not logical or economic nonsense. Such arguments make it easy to ridicule the unhampered market system. A sensible, coordinated program of interventions should be able to improve on its operation.

The very easiness of arguing this way should serve as a warning. It is all too easy to make a list of goods, activities, economic sectors, and kinds of employment that would superficially seem to deserve special encouragement. Yet steering productive resources into favored activities means withholding them from others; and forcing consumers (and industrial users, too) to spend more on particular goods or their substitutes, as by levying import duties, leaves less real purchasing power available for buying the outputs of other sectors of the economy. No one can comprehend such repercussions in concrete detail. Favoring some activities and sectors must disadvantage others, yet no one can know which of those others will suffer most.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

How can one be sure that the shrunken activities might not themselves be especially meritorious in terms of the standard arguments? Political decisions about economic affairs, as the 19th-century economist Frédéric Bastiat (1964, chap. 1) used to argue, suffer from overemphasis on the *seen* to the relative neglect of the *unseen:* Desired and obvious results get too much attention relative to unrecognized repercussions, some of which may occur in remote sectors of the economic system and only after long time lags.

Economists might well agree on the abstract proposition that some specific but unknowable pattern of taxes and subsidies and controls and import duties would be superior to free trade at home and internationally—until ever-changing conditions change what pattern of interventions would be ideal. Yet because they could not know and agree on what specific actual pattern would be ideal, their abstract agreement would be empty, their consensus spurious.

In the real world, interventions have to be applied specifically—such and such an import duty or import quota applied to this product, defined with adequate precision; such and such a kind and rate of subsidy on this other product and tax on that still other one; such and such a job-retraining program with specific features and incentives and disincentives (whether intended or not). The dynamic nature of the world, which the realists and interventionists so much like to harp on in other contexts, poses a further obstacle to achieving and maintaining an ideally adjusted pattern of interventions. (Who, before invention of the transistor, could have predicted it and its immense repercussions?)

Now, do the champions of an industrial policy describe their program in adequate comprehensiveness and detail? Do they even agree among themselves? Do they tell us how to get their program enacted through the political process? It is not enough to say that other countries have industrial policies or to say that the United States has had one of sorts throughout its history.

What needs to be challenged is the idea that the government ought, somehow, to make the pattern of economic activity different from what would emerge in a free market, and that it should do so beyond merely supplying public goods (defense and the like) and charging for them through taxation. The government cannot actually determine the national pattern of production and consumption, let alone achieve for individuals their ultimate goals in life. It cannot systematically and sensibly allot to people the gains and losses always arising from changes in economic life. Government officials can only try to do their best in establishing and tinkering with rules and constraints on people's activities and transactions, trying to conform

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

to broadly accepted notions of morality and justice and hoping that the results will be more satisfactory, by some criterion or other, than the pattern of activities hitherto observed. Operationally, the choice lies between alternative sets of institutions and rules, not between alternative patterns of production and resource allocation and gains and losses. In choosing between alternative rules and institutions, the government has plenty of work to do in helping maintain a framework for justice and free enterprise—peace, security, law, stable money, and the like. (On these issues we recommend Vining 1962 and 1969.)

Controlling a market economy through ideal interventions would require the controllers to have the same knowledge of wants, resources, technology, and all sorts of local and fleeting details that planners would need to operate a centrally planned economy. Here the whole vast literature on central planning and economic calculation under socialism becomes relevant. Like central planning, a program of detailed and supposedly coordinated interventions is bound to perform poorly. The market system does what central planning and intervention cannot do: It puts to use the detailed knowledge that is inevitably scattered about in millions of minds and that simply could not be articulated and assembled for use in central decisions. It achieves spontaneous coordination. It exerts pressures for economic progress. It is not as perfect as one might abstractly imagine, but it works. A free-market economy is attainable; ideal intervention is not.

Furthermore, the policy of allowing the free market to work is a definite program. It has clear meaning. Protectionism, interventionism, industrial policy, or whatever its alternative may be called, on the other hand, is a chimera. What appeal it may have derives largely from its vagueness; it means different concrete measures to its different advocates.

Such advocacy is not new, by the way. Adam Smith had it pegged. Authority to tell private people how to employ their capitals "would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it" (1937, p. 423).

The Politics of Interventionism

Besides considering the economics of the issue, we should give some thought to the politics. Can anyone seriously believe, in this day and age, that the governmental process as it operates in the United States and other democratic countries is capable of producing a coherent program of detailed interventions effectively oriented toward nationally sensible economic objectives? In governmental decision making, responsibility is fragmented, remote and long-run

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

repercussions relatively neglected, and economic theory often scorned. The system has a short-run bias. It is notoriously responsive to special interests. Students of public-choice theory understand by now why our political system is practically bound to operate that way. Can we reasonably expect a sensible industrial policy to emerge from the process that has led, for example, to detailed cost investigations by American officials in a French nitrocellulose plant?

Consider the short-run bias and special-interest bias evident in the record of U.S. economic policies—the system of tariffs and import controls itself; the various farm programs; minimum-wage laws; the Social Security mess; blithe enactment, over the years, of entitlements to benefits without due thought for the long run, resulting now in whopping and ominous government budget deficits; progressive ruination of our money; preposterous attempts at macroeconomic fine-tuning through fiscal and monetary policy, with the Federal Reserve system still being badgered from inside and outside the government on how it should zig and zag; a hopelessly complex, irrational, and even destructive tax system; and so on and on.

We do not say that all government programs fail, but the percentages are not good. Self-congratulating realists, pragmatists, and empiricists should pay attention to the abundant empirical evidence on how our political system actually makes economic policy. Do we really want to expand this system's scope of action?

An industrial policy of the kind fashionably recommended nowadays would be a great new feeding trough for special interests. Interventionists who prate about policy for a dynamic world should remember that political influence lies with businessmen and workers in *existing* industries, not in those still to be created. Concern for the future would depend largely, and inaccurately, on the glamor and voguishness of a few high-tech fields.

As Senator William Proxmire recently said (quoted by Poole 1983):

> Money will go where the political power is. . . . It will go where the union power is mobilized. It will go where the campaign contributors want it to go. It will go where the mayors and governors as well as congressmen and senators have the power to push it. Anyone who thinks government funds will be allocated to firms according to merit has not lived or served in Washington very long.

Protectionist trade policy is a prime example of the modern perversion of democratic government. Instead of being an instrument for identifying and enforcing rules of just conduct, thereby facilitating peaceful and mutually advantageous voluntary cooperation among the members of society, government has become an instrument that special-interest groups strive to wield for their own narrow advan-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

tage. (We conjecture, by the way, that the litigation explosion and the plague of lawyers is another consequence of perceiving government as a tool for getting wealth for oneself by transfers instead of by production.) Democratic politicians, to gain and hold power, strive to stitch together artificial and temporary majorities by buying, in effect, the votes of particular interest groups. As a result, government grows in size and in the scope of its activities.

A remedy cannot be found in the field of trade policy alone. The process that has overburdened democratic government must be reversed. (As distinguished from haphazard and piecemeal interventions working at cross-purposes, comprehensive and detailed, yet coherent, economic planning simply cannot be carried out by the democratic process.) Reform must probably be sought at the constitutional and even spiritual level—in a return to the ideals of free men and women, free markets, and limited government.

We need not expect total victory for such a campaign to be worth while. We can hold down the extent of interventionism and come closer to free markets and limited government by keeping up the intellectual struggle. Interventionists will get their way less often if their arguments are widely perceived as fallacious. After all, everyone seeking special government protection wants others to believe, and wants to believe himself, that action in his own special interest is in the general interest also. That is what he argues. By keeping up the intellectual struggle, those who understand the economics involved will make it harder for such arguments to prevail. Even "unrealistic" ideals can be worth pursuing, as F. A. Hayek has explained in the passage quoted on the back cover of this journal.

References

Allais, Maurice. "Les Théories de l'Équilibre Économique Général et de l'Efficacité Maximale—Impasses Récentes et Nouvelles Perspectives." *Revue d'Economie Politique* 81 (May 1971): 301–409.

Amacher, Ryan C.; Haberler, Gottfried; and Willett, Thomas D., eds. *Challenges to a Liberal International Economic Order*. Washington: American Enterprise Institute, 1979.

Bastiat, Frédéric. "What Is Seen and What Is Not Seen." Reprinted as chapter 1 in his *Selected Essays on Political Economy*. Translated by Seymour Cain. Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1964.

Beveridge, William Henry, and a committee of economists. *Tariffs: The Case Examined*. 2d ed. London: Longmans, Green, 1932.

Dorn, James A. "Trade Adjustment Assistance: A Case of Government Failure." *Cato Journal* 2 (Winter 1982): 865–905.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Evans, Rowland, and Novak, Robert. "Protectionism: A Call to Chaos." *Reader's Digest* 128 (August 1983): 100–104.
Garten, Jeffrey E. "For a Trade Policy Founded on Realism." *New York Times*, 12 January 1983.
Harrigan, Anthony. "Needed: A Strategic Economic Policy." *National Review* 35 (4 March 1983): 240–45.
Hayek, Friedrich A. "Principles or Expediency." In *Toward Liberty* (Festschrift for Ludwig von Mises). Menlo Park, Calif.: Institute for Humane Studies, 1971. Vol. 1, pp. 29–45.
Hayek, Friedrich A. *Law, Legislation, and Liberty*. Vol. 2: *The Mirage of Social Justice*. Chicago: University of Chicago Press, Phoenix Books, 1978.
Hutt, W.H. *Politically Impossible . . . ?* London: Institute of Economic Affairs, 1971.
Krauss, Melvyn B. *The New Protectionism: The Welfare State and International Trade*. New York: New York University Press, 1978.
Kuttner, Bob. "The Free Trade Fallacy." *New Republic*, 28 March 1983, pp. 16–21.
LTV Corporation. Advertisement in *Wall Street Journal*, 7 June 1983a, p. 15.
LTV Corporation. *Congress and U.S. Trade Policy*. Dallas: LTV Corporation, 1983b.
Miller, G. William, ed. *Regrowing the American Economy*. Englewood Cliffs, N.J.: Prentice-Hall, 1983.
Olson, Walter. "Don't Slam the Door." *National Review* 35 (4 March 1983): 248–52, 273.
Philbrook, Clarence E. " 'Realism' in Policy Espousal." *American Economic Review* 43 (December 1953): 846–59.
Poole, Robert, Jr. "Healing American Industry" (an editorial). *Reason* 15 (August 1983): 6.
Reich, Robert B. "Beyond Free Trade." *Foreign Affairs* 61 (Spring 1983): 773–804.
Silk, Leonard, *The Economists*. New York: Avon Books, 1978.
Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations*. 1776. Reprint. New York: Random House, Modern Library, 1937.
Spencer, Herbert. *The Principles of Ethics*. 1897; parts published earlier. 2 vols. Indianapolis: Liberty Classics, 1978.
U.S. Department of Commerce, International Trade Administration. "Industrial Nitrocellulose from France: Final Determination of Sales at Less than Fair Value." Typescript, 9 May 1983.
Vining, Rutledge. "On the Problem of Recognizing and Diagnosing Faultiness in Observed Performance of an Economic System." *Journal of Law and Economics* 5 (October 1962): 166–69.
Vining, Rutledge. "On Two Foundation Concepts of the Theory of Political Economy." *Journal of Political Economy* 77 (March/April 1969): 199–218.
Yeager, Leland B. "Pareto Optimality in Policy Espousal." *Journal of Libertarian Studies* 2 (Fall 1978): 199–216.
Yeager, Leland B., and Tuerck, David G. *Trade Policy and the Price System*. Scranton, Pa.: International Textbook Co., 1966.
Yeager, Leland B., and Tuerck, David G. *Foreign Trade and U.S. Policy: The Case for Free International Trade*. New York: Praeger Publishers, 1976.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ECONOMICS AND PROTECTIONIST PREMISES

Ronald A. Krieger

In their paper "Realism and Free-Trade Policy," Professors Yeager and Tuerck have skillfully demolished the arguments of the so-called "new realist" and "new protectionist" schools and have marshaled eloquent arguments for the superiority of realistic market solutions over an impractical idealized interventionism. Yet I am struck by their statement that they are becoming rather "frustrated by the protectionists' inattention" to the standard arguments used by free traders against protectionism.[1]

This admission brings to mind the tale of the economist who was invited to dinner at the home of a certain captain of industry. They took to arguing about free markets and free trade, and the dispute became more and more heated. Finally, the industrialist pointed to the door and shouted, "Sir, get off my premises!" To which the economist replied in total frustration, "Sir, I *am* your premises."

The Nature of the Conflict

Unfortunately, the person of affairs will seldom acknowledge that the premises articulated by members of the economics profession govern the day-to-day business environment. Yet the debate over protectionism is largely a conflict over basic premises. And we economists are likely to continue to be "frustrated by the protectionists' inattention" until we can convince "practical" people of the relevance, power, and accuracy of the premises with which we approach issues of economic policy.

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Vice President and the Director of Economic Publications at Chase Manhattan Bank, N.A., New York, N.Y. 10081.

[1]Leland B. Yeager and David G. Tuerck, "Realism and Free-Trade Policy," *Cato Journal* 3 (Winter 1983/84): 657.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

At the heart of the protectionist case—be it the "new realism" that challenges the ethical basis of free trade or merely the familiar tenets of old-fashioned mercantilism—is a view of the world that differs sharply from that held, in the main, by those trained in economics. In Table 1, I list a series of simplified propositions, contrasting the basic premises of what I will call the "economist's view" with those of the "non-economist's view." I recognize that the former is not entirely confined to economists and that (regrettably) some members of the economics profession may agree with one or more tenets of the latter. But in the main, the distinction strikes me as valid.

The Economist's View

Let us take up in order the propositions listed in Table 1, starting with the economist's viewpoint:

A. The purpose of economic activity is to enhance the well-being of individual consumers and households. This is an absolutely basic premise of economics, from which all the other propositions follow.[2]

TABLE 1

TWO VIEWS OF THE WORLD

	Concept	Economist	Non-Economist
A.	The purpose of economic activity is . . .	consumer welfare	jobs and growth
B.	The basic element of economic activity is . . .	exchange	production
C.	Work is a . . .	cost	benefit
D.	Imports are a . . .	benefit	cost
E.	Exports are a . . .	cost	benefit
F.	Cheap foreign goods are a . . .	benefit	cost
G.	The objective of trade is to . . .	get goods cheaply	create jobs
H.	Trade barriers hurt . . .	domestic residents and foreigners	foreigners only

[2]Adam Smith said it succinctly in 1776: "Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it. But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce." *The Wealth of Nations,* Modern Library ed. (New York: Random House, 1937), p. 625.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

B. The basic element of economic activity is the transaction or exchange, which, if informed and uncoerced, must necessarily augment the wealth—the utility, well-being, or satisfaction—of both parties to the transaction. If producers who are not parties to the exchange—"third-party producers"—are damaged, they can (in principle) be compensated out of the gains from the exchange. However, efficiency and general-welfare considerations suggest that these producers should reallocate their resources to higher-valued uses.

C. Work is a cost or an obstacle to be overcome or endured in producing the benefits of consumption. Wants always exceed the ability of scarce resources to satisfy them, so there is always plenty of work to be done. Unemployment is thus a disequilibrium situation, resulting from a perverse incentive structure or from sluggish adjustments to changing labor-market conditions.

D/E. Imports are the benefit for which exports are the cost.

F. Cheap foreign goods are thus an unambiguous benefit to the importing country.

G. The objective of foreign trade is therefore to get goods on advantageous terms.

H. Trade barriers damage the economic well-being of both the protectionist country and its trading partners.

The Non-Economist's View

The economist's views will generally be disputed in every instance by persons untrained or only partially educated in economics, who tend to hold the following views:

A. The purpose of economic activity is to foster employment and economic growth.

B. The basic element of economic activity is production, which has as its purpose the well-being of the suppliers of the factors of production: land, labor, and capital. Transactions that damage third-party productive factors—those outside the exchange—are detrimental to economic well-being.

C. Work is a benefit. Jobs are a "good" with positive utility, to be purchased at a cost, if necessary, by sacrificing some (presumably selfish, materialistic, hedonistic, or unneeded) consumption. The market economy tends to generate underemployment and unemployment. The government must therefore intervene through a variety of measures, including

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

trade barriers, in order to provide enough desirable jobs to accommodate everyone who wishes to hold one.

D/E. Exports are the benefit for which imports are the cost.

F. Cheap foreign goods are a disaster for the importing country, devastating its economy by destroying jobs.

G. The objective of foreign trade is therefore to create more jobs at home through exports than are destroyed by imports.

H. Trade barriers hurt only foreigners. Protection enhances the economic well-being of the populace of the home country.

Defending Free Trade

With this wide gap in perceptions and assumptions, it is small wonder that "practical people" listen uncomprehendingly to free-trade arguments based on premises they find preposterous. When no one is listening, it counts for little that we can demonstrate the superiority of the economist's point of view through rigorous internal logic. Rigorously derived conclusions are only as acceptable as the premises from which they proceed, and it is the body of premises supporting free trade—not the logic—that is under attack.

In this situation, it is an evasion for economists to retreat to the theoretical high ground, taking shelter and comfort in the rigor of our logic while complaining that our cogent arguments fall on deaf ears. We have a responsibility to make ourselves heard as professional economists, and we can do so only by mounting a frontal assault on the underlying premises of protectionism. This means taking the battle to the protectionists' turf and confronting head-on their misconceptions about "realism," job creation, and the content and purpose of economic activity. If economists' premises can win acceptance, the free-trade case will prevail.[3] I therefore propose a three-pronged attack:

- As Yeager and Tuerck have done so well, we must continue to hammer away at the impracticality of idealized interventionism. If the protectionists want to be "realistic," let us by all means give them realism, by stressing at every opportunity the lack of operational validity of protectionist policies.
- We must confront and demolish the employment arguments that have become widely accepted by political leaders, members of

[3]Although Yeager and Tuerck are becoming somewhat frustrated with repeating the arguments for free trade, they recognize the importance of such repetition and encourage others to restate the arguments "in fresh and compelling ways." Yeager and Tuerck, p. 657.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the press, and the general public. Take, for example, this unattributed assertion from a recent *Business Week* cover story: "The trade deficit is already costing 1.5 million jobs, shrinking the nation's industrial base, and sapping the economy's growth potential."[4] But do exports really create jobs? Or, for that matter, do imports reduce domestic employment? For the economy as a whole, a "job-creating" increase in exports will tend to induce either an offsetting rise in imports or a capital outflow that, by forcing up interest rates, will promote an offsetting job loss in interest-sensitive sectors. In the long run, foreign trade only rearranges employment patterns, redistributing labor to more-productive occupations. The typical protectionist argument simply assumes (incorrectly) that the jobs gained from protecting a particular industry increase employment, output, and economic growth for the economy as a whole. This is a classic case of the fallacy of composition, since job expansion in the protected sector is normally offset by employment losses elsewhere in the economy. There is an abundant literature in macroeconomics attesting to the futility of trying to create jobs through trade barriers,[5] and we must see to it that fallacious arguments in this vein are countered at every opportunity.

- Finally, we must continue to stress the purpose and content of economic activity. Consumers are shrewd judges of their own self-interest. Once they are disabused of the notion that their sacrifices serve to reduce unemployment, they are not likely to tolerate the unfairness of special interests profiting at the expense of the many.

A Re-education Problem

In this connection, we have a re-education problem within the economics profession, in the production and use of elementary teaching materials. The majority of college-educated citizens of the postwar generations learned their economics from textbooks that presented sterile microeconomic (perfect-competition) and macroeconomic (multiplier) models. Although it probably was not the intention of most instructors, their students took from these models the nonsensical propositions that (1) the case for free markets breaks down when

[4]"America's Hidden Problem: The Huge Trade Deficit Is Sapping Growth and Exporting Jobs," *Business Week*, 29 August 1983, pp. 66–77.

[5]See, for example, the discussion and references in Brian Hindley and Eri Nicolaides, *Taking the New Protectionism Seriously*, Thames Essay no. 34 (London: Trade Policy Research Center, 1983), chaps. 3–4.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the assumptions of perfect competition are not perfectly met, and (2) exports stimulate a multiple expansion of output and employment while imports are a "leakage" that induces a multiple contraction. Even if some astute instructors stressed the robustness of market solutions under rivalrous behavior and the partial nature and dubious validity of multiplier analysis, such lessons generally failed to take.

Thus, we must point to our own teaching and textbooks in assigning responsibility for the failure of much of the population to see the world from the economist's point of view. Until we improve our own teaching methods and free ourselves from the obsolete approaches to economic theory that permeate many of the popular textbooks, we will have only ourselves to blame for the public's misconceptions about free markets and free trade.[6]

[6]There are several refreshing exceptions to the mechanistic sterility of the traditional principles textbooks. An outstanding example is Paul Heyne, *The Economic Way of Thinking*, 4th ed. (Palo Alto, Calif.: Science Research Associates, 1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

PROTECTIONISM, THE WELFARE STATE AND THE THIRD WORLD

Melvyn Krauss

Introduction

American liberals and European social democrats appear to suffer from split personalities. With one exception, they believe government should intervene anywhere and everywhere in the economy. That exception is foreign trade. It is hard to meet a liberal-left economist these days who does not believe simultaneously in the welfare state and free trade.

How can the leftist support for free trade be explained? Are they "closet Ricardians" in left-wing drag? On the contrary, adherence to free trade for leftists has little to do with their belief in David Ricardo's theory of comparative advantage. If it did, they would not be interventionists in the first place. Comparative cost theory applies as much to internal as international economic exchange.

"Internationalism" better explains the free trade sentiments of the left-leaning economists. Like anti-Semitism, protectionism no longer is quite respectable in intellectual circles. International cooperation has become the social democrats' *sine qua non*, while protectionism and the beggar-my-neighbor policies of the 1930s are viewed as the nadir of what respectable foreign economic policy should be. So long as internationalism remains fashionable, the social democrats and their fellow travelers can be expected to suppress their interventionist instincts as far as foreign trade is concerned.

The intellectual inconsistency of free trade on the one hand and the welfare state on the other is obvious once one realizes that the welfare state is itself the major motivation for protectionism presently

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at New York University and a Senior Fellow at the Hoover Institution, Stanford, Calif. 94305.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

existing in the global economy. To be in favor of the welfare state *ipso facto* is to be in favor of protectionism. Left-leaning economists want to have it both ways. But in serious intellectual life that simply is not possible.

The New Protectionism

Mercantilism, at least in the Baron Von Hornick sense of the term, no longer is the force it once was in international commercial policy. Nor is the character of protectionism today neo-Marxist. Labor versus capital sounds as outdated as Louis vs. Schmeling, Mays vs. Mantle, and Truman vs. Dewey. In today's world, and perhaps yesterday's as well, labor and capital in certain uses conspire together against labor and capital in other competing uses. Thus, in the United States, for example, labor and capital in the steel industry conspire against labor and capital in export industries. Protectionism, in other words, appears more an interindustry conflict than an interfactorial one. Most economists, however, cling to their Stolper-Samuelson, labor versus capital, conceptual apparatus for viewing this problem.

In my book *The New Protectionism,* I noted that the character of protectionism has changed to accommodate internationalist sensibilities.[1] Instead of tariffs and quotas, the subsidy has become the prime protectionist device in the industrial countries. Because they do not explicitly discriminate between the foreign and domestic sectors of the economy, subsidies do not appear as beggar-my-neighbor as do tariffs.

Appearances may accommodate the fashionable affectations of the internationalists. But the subsidy is just as deadly, even more so than conventional protective devices, for at least two reasons:

1. The protective effect of subsidies is not as obvious or subject to empirical verification as that of tariffs and quotas.
2. Governments consider subsidies as a purely domestic matter and thus are less willing to subject them to international negotiations.

Protectionism rendered by subsidies, in other words, is harder to combat than protectionism rendered in the conventional manner.

Subsidies serve a variety of purposes in the welfare state. One is to enforce welfare-state objectives of promoting labor immobility. In a competitive economy, of course, labor movement is essential to

[1]Melvyn B. Krauss, *The New Protectionism: The Welfare State and International Trade* (New York: New York University Press, 1978.)

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

promote efficiency in the allocation of resources. But today the welfare state frowns upon labor mobility, because of its alleged negative social impact. The present belief is that a proper function of government is to bring work to the workers—via subsidies—rather than workers going to work via the free market.

The result is not only a misallocation of resources in the domestic economy, but international protectionism since the subsidy either blocks the entry of competitive goods from abroad or encourages their export from the welfare state.

The Pitfalls of Industrial Policy

Those who advocate a "new industrial policy" for the United States—namely, Robert Reich and Lester Thurow—are precisely the types I refer to as favoring free trade only in the sense of being against tariffs and quotas. Their championing of the subsidy makes it easy and profitable for protectionists to forego the tariff; the subsidy is all that they need to obtain their objectives. The subsidy, in other words, has become a wolf dressed in sheep's clothes. And the neo-liberal version of free trade is free trade without a bite.

Moreover, Reich and Thurow's "new industrial policy" simultaneously favors government subsidizing labor immobility for social reasons, and a reallocation of government subsidy efforts from supporting sunset to sunrise industries. If ever there was a cacophonic "fiddling on the roof," the "new industrial policy" is it.

The very reason governments subsidize sunset industries in the welfare state is to prevent labor mobility. Strong industries do not need subsidization because their very strength protects them from international competition. The subsidized industries are the ones subject to shifting comparative advantages. Steel, for example, is an industry in which the focus of efficient production has shifted from Northern Europe and America to the Pacific rim area. Textiles and apparel are further examples.

It simply is not possible for governments to practice more efficient subsidization at home while, at the same time, defending workers from labor mobility. Robert Reich has an excuse at least—he was not trained as an economist. But Lester Thurow is a professor in one of the country's most prestigious economics departments.

Subsidies to defend workers against labor mobility are part of the "workers' rights" movement, particularly in the Northern European welfare states. Citizens of the welfare state believe they all have a right, not only to free speech, press, and assembly but to a job, in the industry of their choice, at the geographic location of their choice,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

and at an income that permits politically determined minimum-consumption standards. Equal political and economic rights go hand in hand in the welfare state.[2]

To secure citizens their economic rights, government may subsidize labor and capital in low-productivity uses. Subsidies to inefficient private firms constituted a high-growth factor in the public budgets of the welfare states during the 1970s. Nationalization of private firms is on the increase in the welfare state for the same reason. While it is generally recognized that "workers' rights" programs damage the overall economy of the subsidizing country, it has not been recognized that they strongly disadvantage the economies of the poorer nations as well.

Consider, for example, a less developed country (LDC) that becomes an international competitor in the production of standardized steel products. If the world economy operated on a free-market basis, the locus of production of standardized steel products would shift from the developed to the less-developed countries. For the LDC this would mean a reallocation of domestic resources from other industries to steel. The reverse would be true in the industrialized country. Both would be made better off by these reallocations because they imply in each country a shift of factor resources from low-productivity to high-productivity uses.

But the relocation of factor resources is likely to be resisted in the developed country if it is a welfare state. Because of workers' rights programs, steelworkers can be expected to insist that the welfare-state government "protect their rights" by subsidizing the domestic steel industry, even though the workers could protect their rights by taking a necessary cut in pay to keep the firms they work for in business. The subsidy, by artificially lowering the costs of the domestic steel industry, prevents the industry's contraction and thus the need for steelworkers to find jobs in other locales. Unfortunately for the LDCs, the subsidy also prevents its steel products from entering the market of the welfare state. Had government allowed the steel industry in the social democracy to go out of business or shrink, steelworkers either would have had to accept a cut in wages or lose their jobs to their Third World counterparts.

This example makes it clear that at least part of the cost of subsidizing inefficient workers in sunset industries in the developing countries is borne by competitive industries in the Third World. Furthermore, workers in the LDCs are being hurt not because the

[2]See Melvyn B. Krauss, "Ill Fares the Welfare State," *Policy Review* 18 (Fall 1981): 133–38.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

steelworkers in the welfare state face certain unemployment, but because the steelworkers refuse either to accept pay cuts in their present jobs or to accept jobs in other industries or locales. The welfare-state worker makes exacting demands on the government. And it is the LDC worker who often must pay.

It is interesting, in this regard, to note that Northern European social democrats and American liberals see themselves as the champions of the Third World interests. But no amount of conscience money—that is, foreign aid—is going to change the fact that what the social democrats give in aid, they more than take away by restricting trade.[3]

Because the internationalism of the left is based on fashion rather than sound economic doctrine, its scope has been rather limited to explicit international trade-restricting devices. But international *trade* is only one facet of international economic *exchange;* there is also international capital and labor mobility to consider. In some ultimate sense, the three forms of international exchange can be substitutes for one another. Restrictions on international trade can provoke more capital and/or labor mobility between nations than otherwise would have occurred, and vice versa. International economic exchange would be truly cut off only if all three of its facets were closed down.

The internationalism of the left does not extend to international capital and labor flows. American liberals and European social democrats support both restrictions on capital outflow to protect against the alleged "export of jobs" to foreigners, and restrictions on labor inflow to protect the bloated real wages the welfare state has bestowed upon workers in the industrialized countries. This is but another way the welfare state damages Third World countries. Cheap wages in the South attract capital there, while dear wages in the North attract labor here. International labor and capital flows thus are two of the three ways prosperity gets transferred from North to South.

The international transfer of prosperity via international exchange is preferable to the international transfer of income favored by the left, at least if one is interested in raising the living standards in the less developed world. But the transfer of prosperity is blocked by the welfare-state programs that subsidize both labor and capital within their confines.

Labor subsidization in the welfare state is only part of the problem. Capital subsidization also offends since it artificially keeps capital from seeking higher productive returns elsewhere. In the welfare

[3]See Melvyn B. Krauss, *Development Without Aid* (New York: McGraw-Hill, 1983), especially chap. 7.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

state, programs are evolving for "capital rights" as well as for "worker rights." It must always be remembered that the welfare state is just a variant of Mussolini's "corporate state," whose claim to intellectual respectability and early source of appeal to such personages as Franklin Delano Roosevelt and Gunnar Myrdal was that it alleged to reconcile the Marxian conflict between labor and capital. The welfare state, I suggest, should be viewed more in "corporativist" terms than Marxian ones.[4]

The Anti-Growth Bias

A further way the welfare state damages the Third World—in addition to promoting protectionism—is to downplay the importance of economic growth. Economic growth is said to ruin the environment. And in societies where leisure has become a way of life, the hard work that economic growth implies has become anathema. This is tragic for the poorer nations of the world economy whose very survival depends upon rapid growth in the industrialized countries.

Of course, fashionable Club of Rome biases against economic growth have something of the "let's make a virtue out of a vice" about them. When the Northern European welfare states were growing well in the 1950s and 1960s, economic growth was not considered such a bad thing. But the "sick seventies" have demonstrated that economic growth is incompatible with both the high taxes and many of the social welfare programs that are endemic to the modern welfare state. Rather than face up to the long-run consequences of this incompatibility, it is much more comfortable for welfare-state advocates to put their heads in the sand and make believe growth no longer counts.

It only will be when the welfare state in the northern industrial powers is dismantled that protectionism there will cease to be a problem for the Third World.

[4]See Melvyn B. Krauss, "Reich's Friendly Fascism," *The American Spectator* (September 1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

U.S. TRADE POLICY: HISTORY AND EVIDENCE

Victor A. Canto

Introduction

For the past 13 years, U.S. trade policy has been on a steady course toward increased protectionism. A policy to reduce tariffs across the board among all trading nations has been paralleled by efforts to protect selected industries from foreign competition. In the vernacular, the call for "free" trade has been joined by the admonition to seek "fair" trade. An increasing number of people have advocated protectionist policies in an effort to create a favorable balance of trade. Foreign competition increasingly is blamed for the decline in the health of the U.S. economy while problems of several of the economy's weakest sectors, including steel and autos, are attributed to an uncontrolled surge of imports.

The debate now is much the same as it was 200 years ago. Arguments today that favor increased protectionism incorporate several of the mercantilist concepts, including the importance of a positive trade balance to a nation's prosperity. By contrast, the economic principles invoked by those advocating free trade can be found in the writing of Adam Smith and his predecessors. The trade account is viewed as a means to provide consumers and producers with the widest possible access to foreign goods and markets. Though restrictions placed on trade by foreign nations can be harmful to the domestic economy, imposing additional restrictions on trade at the domestic level serves only to compound the loss of economic efficiency, limiting further the opportunities to realize the benefits of trade.

The historical account of the U.S. trade policy presented in this paper suggests that the rise of protectionist policies can be linked to

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Associate Professor of Finance and Business Economics at the University of Southern California, Los Angeles, Calif. 90089. He wishes to thank A. B. Laffer, R. V. Eastin, and C. W. Kadlec for their comments and suggestions.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the concern for the international competitiveness of U.S. products. The enthusiasm for restricting trade as a means to improve the domestic economy and protect selected industries, however, is tempered by the realization that trade restrictions can become counterproductive, impoverishing domestic and foreign producers and consumers alike.

Historical Survey of U.S. Trade Policies

The Trade Agreements Act of 1934

The roots of current U.S. trade policies can be traced back to the Trade Agreements Act of 1934. The purpose of this act, passed by the U.S. Congress, was to increase United States exports to foreign countries. There was a need for such an act for two reasons. First, the Smoot-Hawley Tariff Act of 1930 raised duties on imports to 53 percent in 1931 and 59 percent in 1932. This action provoked other countries to retaliate against the U.S., shrinking world trade. Second, the ensuing worldwide contraction in economic activity in the early 1930s caused world trade to decline even further. Between 1929 and 1933, world trade shrank 25 percent.

The Trade Agreements Act of 1934 delegated to the president the authority to negotiate U.S. trade agreements. It also allowed the president to participate in negotiations for the purpose of lowering tariffs to a level as low as 50 percent of the rates established by the Smoot-Hawley Act.

Extensions of the Trade Agreements Act, particularly after World War II, permitted the imposition of restrictions when harmful domestic effects could be shown to result from tariff cuts. Nevertheless, under the act, the United States signed bilateral trade agreements with 20 foreign nations. And, by 1947, tariff rates had been reduced to one-half their 1934 levels.

The General Agreement on Tariffs and Trade

In spite of this progress, it was apparent that, in the years preceding World War II, an alarming number of nations had adopted a neomercantilist, "beggar-thy-neighbor" approach to trade policy. Many politicians and commentators specifically attributed the outbreak of war to that trade environment.

This feeling served as the underpinning for the major international efforts following the war in which open communication, free trade and international economic interdependence were basic goals. Thus, the United Nations, the Bretton Woods agreement, and the General Agreement on Tariffs and Trade (GATT) were formed—all through the leadership of the United States.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

GATT is particularly noteworthy for purposes of this study. It institutionalized the following basic goals:

1. Trade without discrimination (general, most-favored-nation treatment);
2. Protection of domestic industries only through tariffs;
3. Establishment of a predictable and stable basis for trade;
4. Consultation when trade problems arise;
5. Waivers and emergency actions that serve as exceptions to the general rules (e.g., escape clauses); and
6. Acceptance of regional trading arrangements.

Under the provisions of GATT, seven rounds of trade negotiations occurred: in 1947 (Geneva), 1949 (Annecy, France), 1951 (Torquay, England), 1956 (Geneva), 1961 (Dillon Round, Geneva), 1964 (Kennedy Round, Geneva), and 1975 (Tokyo Round, Geneva).

The Trade Expansion Act of 1962

During the span between 1947 and the mid-1950s, trade barriers were reduced on a commodity-by-commodity basis. After the mid-1950s, however, this method was considered ineffective for large-scale reductions. Participants in GATT therefore requested a "linear," or across-the-board, approach to tariff cuts. Such an approach was authorized when Congress passed the Trade Expansion Act of 1962.

The Trade Expansion Act was the most significant piece of trade legislation since the adoption of the Reciprocal Trade Agreements Act in 1934. This legislation was the statutory mandate for the president to negotiate tariff cuts at the next GATT-sponsored multilateral trade negotiations, later to be called the Kennedy Round. This act was significant for another reason: It established the office of the special trade representative (now the U.S. trade representative) to conduct the negotiations, replacing the State Department in this role. The purpose behind this shift was to meet congressional concerns that the State Department was too prone to negotiate trade agreements based on nebulous foreign policy grounds. Thus, trade policy was made less a stepchild of foreign policy and more subject to commercial realities and special-interest pressures.

The Kennedy Round. The Kennedy Round had three major objectives: (1) Overall reduction in tariffs, (2) reduction of nontariff barriers, and (3) participation of less-developed countries. Of these three objectives, reduction of tariffs was the most successful. The reduction of nontariff barriers was not as successful as had been hoped.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Import duties were cut an average of 35 percent on manufactured goods and 20 percent on agricultural products (excluding cereals, meat and dairy products). In all, about 70 percent of imported items were included in the cuts. By the end of the Kennedy Round, tariffs in the United States, the European Community, and Japan averaged only about 10 percent.

The Kennedy Round was also the first set of negotiations that addressed the problem of nontariff barriers, including:

1. Technical Barriers—mainly product standards, labeling and packaging restrictions, statements of origin, etc.;
2. Anti-dumping Policies—selling a product in a foreign market below the price charged by manufacturers in its home market or below cost;
3. The Government Procurement Code—regularizing and opening up procedures for government so that international sellers have better access to government contracts; and
4. The Customs Valuation Code—the evaluation of products for tariff purposes, nomenclature, and related customs procedures.

The inability of the participants to reach agreement in the reduction of nontariff barriers, however, anticipated many of the trade-related problems of the 1970s.

The Kennedy Round was concluded on June 30, 1967, when 53 nations signed agreements to put four years of negotiations into effect. The agreements were implemented over a five-year period ending in 1972. During the late 1960s, however, the steel and textile industries became primary advocates of restricting import competition. The Nixon administration responded to this pressure by endorsing textile and steel quotas. Also, the lack of international negotiations and the failure of GATT as an institution to resolve trade problems caused protectionist legislation to be introduced in Congress. While such legislation, epitomized by the Mills bill and the Burke-Hartke bill, never became law, it emphasized the growing pressure by special domestic interests to cope with the increasing pains of free trade and open-market policies.

New Forms of Trade Restraints

"Voluntary" Restraints. On January 1, 1969, the United States entered into voluntary restraint agreements with countries exporting all types of steel into the United States. Domestic manufacturers of steel called for these restraints because they feared injury from

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the tremendous increase of imported steel.[1] These restrictions were in effect until December 31, 1971. A second set of "voluntary" restraints was imposed January 1, 1972, which extended the restrictions until December 31, 1974.

President Nixon, in an effort to adhere to a 1968 campaign pledge, asked Japan and other countries to apply "voluntary" quotas on their exports of woolens and synthetic textiles to the United States. Because Japan was reluctant to abide by the "voluntary" quotas, the chairman of the House Ways and Means Committee, Wilbur Mills, with encouragement from the administration, introduced a bill in May 1969 to limit textile imports to their average annual level recorded in 1967 and 1968.

The Trade Bill of 1970. This action was a sharp departure from more than 30 years of U.S. leadership toward liberalizing trade. In the closed sessions that followed, the committee converted the president's bill into the most protectionist legislation since the Smoot-Hawley Act of 1930. It permitted any industry, when threatened by imports, to seek and obtain protection.

The bill was opposed by the European Economic Community. European governments threatened to retaliate if the bill became law. In spite of heavy opposition to the bill within the United States, especially among major exporters and multinationals, the House of Representatives passed it in November 1970. The Senate also appeared ready to pass the bill. But it adjourned before the vote could be taken, leaving the trade issue to be taken up anew by the next Congress as it convened in January 1971.[2]

The Burke-Hartke Bill. The near passage of the Trade Act of 1970 encouraged protectionist groups to seek even greater limits to free trade. Representative Burke and Senator Hartke placed a bill before Congress called the Foreign Trade and Investment Act of 1972, the Burke-Hartke bill. The objective of this bill was to provide for significant increases in government intrusion and regulation of the international flow of goods and capital. This bill was never passed, but it set the terms of the trade debate for the first half of the decade.

The Burke-Hartke bill combined traditional protectionism (import restrictions) with new forms of protectionism, including restrictions

[1]See "The Attractions of Quotas," *Wall Street Journal*, 15 January 1969, p. 18.

[2]For a discussion of the debate on the 1970 trade bill, see "Economists Warn Peril of SST if Trade Bill Passes," and "Trade Bill Foes Lose Hard Fight on Amendment," *Wall Street Journal*, 19 November 1970, p. 3; "House Approves Controversial Trade Measure," *Wall Street Journal*, 20 November 1970, p. 4.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

on direct foreign investment. In addition, a foreign trade and investment commission, composed of three persons appointed by the president and confirmed by the Senate, would have been established. The commission would have been required to restrict imports to the average quantity for the period 1965–69. The commission's other responsibilities would have included estimating production schedules for various categories of goods from the previous year and fixing import quotas for each category and its supplying country. In order to grant an exception to these limits, the commission was supposed to act, in effect, as a central planning agency for the major sectors of the U.S. economy. The protectionist movement of Burke-Hartke would have frozen the 1967–69 ratio of imported goods to the production of "similar" domestic goods for an undetermined amount of time. It also attempted to freeze the geographic patterns of goods in each category.

The Demise of Bretton Woods. During this same period, the Bretton Woods agreement on international monetary policy collapsed. In August 1971, President Nixon, in violation of the Bretton Woods agreement, refused to convert dollars into gold for foreign central banks. The dollar was devalued 8.6 percent relative to gold, making the official price of an ounce of gold $38. Tariffs were increased across the board by 10 percent, and wage and price controls were imposed on the domestic economy. In December of that year, the tariff increase was rescinded and, under the Smithsonian agreement, the devaluation of the dollar against gold was "approved." A general realignment of currency values relative to the dollar also was established. The value of the dollar, however, remained under pressure. Gold convertibility was not restored. And, in February 1973, the United States devalued the dollar by another 10 percent relative to gold and, implicitly, relative to most foreign currencies as well.[3] In the months that followed, one country after another halted efforts to maintain a fixed exchange rate with the dollar, ushering in the present system of floating exchange rates. Efforts to restore dollar/gold convertibility ceased.

The fracturing of the international monetary system and the shift in the trade debate toward extreme protectionism represented by the Burke-Hartke bill paved the way for advocates of selective limits on foreign competition to appear moderate and constructive.

[3]For a discussion of the major trade issues at the time, see "U.S. Devalues Dollar 10% by Raising Price of Gold; Japan Agrees to Let Yen Float," *Wall Street Journal*, 13 February 1973, p. 3.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The Trade Act of 1974

The Trade Act of 1974 provided the broadest congressional mandate in history for the conduct of trade negotiations regarding the reduction of both tariff and nontariff barriers. The president was authorized to reduce tariffs as much as 60 percent below the levels that prevailed at the close of the Kennedy Round. It also called upon the president to begin negotiations for the purpose of strengthening the GATT system so that it could serve the purpose that the multilateral negotiations had served: diffusing and resolving trade conflicts.

However, in response to industry and congressional pressure, the cost of this broad mandate was the adoption of several provisions that eased the criteria necessary for imposing trade restraints. These included more flexible criteria for relief from increasing (but "fair") import competition, as well as substantive and procedural revisions of unfair trade practice laws (such as the antidumping and countervailing duty statutes). Thus, in addressing problems created by import competition that is considered to be "fair," the Trade Act of 1974 provided that an industry no longer need demonstrate that its injury was caused by imports resulting from an earlier tariff concession or that imports are the "major" cause—i.e., a cause no less important than any other cause—of its injury. Under the 1974 Trade Act, an industry need only show that imports are a "substantial" cause. If the International Trade Commission (ITC) finds injury, the president then must consider what impact trade restrictions would have on the domestic economy, consumers, and the overall national interests. The final determination of what action, if any, should be taken is, essentially, at his discretion. The ITC may, however, recommend adjustment assistance instead of trade restrictions. If the president does not proclaim the relief recommended by the ITC, Congress may override the president and institute the relief recommended by the commission.

The authority of the president to impose quantity restrictions was increased: For the first time, the president was authorized to negotiate orderly marketing agreements as a form of relief under the escape clause. The act also required the fulfillment of reciprocity in trade concessions before a trade agreement could be binding between the United States and another major industrial country. The Trade Act of 1974 triggered a rash of demands by U.S. industries for relief from import competition. These included requests for antidumping and countervailing duties, as well as escape clause restrictions on such items as chemical products, steel products, consumer electronics, industrial fasteners, canned hams, and vinyl shoes.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Changes in tariff policies were specifically circumscribed by GATT.[4] The GATT agreements also sought to prohibit the use of quantitative restrictions, which were viewed as more harmful than tariffs. However, these prohibitions were not specific enough to prevent circumvention through quantitative restrictions that were quotas in all but name. Moreover, various kinds of nontariff barriers were introduced on a plethora of products. Among the most complex of these arrangements were the multifiber arrangements, establishing the parameters for restricting textile imports by the industrialized countries (effective January 1, 1974).

The use of "voluntary export restraints" also expanded during the 1970s. Under this arrangement, the importing country negotiates an agreement with the exporting country for that country to limit "voluntarily" the amounts of certain exports. In the United States, such negotiated trade restrictions, in the form of orderly marketing agreements, have been imposed on specialty steels, color TV receivers, nonrubber footwear, certain meats, mushrooms, textiles and automobiles. In 1976 the president obtained an orderly marketing agreement to limit specialty steel exports with Japan, and unilateral quotas were imposed on imports from the EEC and various countries.

The Tokyo Round. Under the Trade Act of 1974, the president entered into the Tokyo Round of Multilateral Trade Negotiations. Once again, tariff reductions were high on the agenda. But reduction of nontariff barriers also were considered an integral part of the negotiations. The agreements reached were signed in December 1978, and represented potential progress in both tariff and nontariff reductions.

Tariff reductions averaged about 30 percent for the United States, 22 percent for Japan, and 27 percent for the European Economic Community. Nontariff reductions centered on the codes discussed earlier but generally were attempts to make trade-barrier activities transparent and explicit rather than hidden. The tariff reductions centered on "harmonization," wherein higher tariffs are reduced by a higher percentage than lower tariffs. Agreement was achieved on the "Swiss formula" with exceptions made for particularly sensitive commodities.[5] Had the Swiss formula been applied in its strictest

[4]The views of GATT's director general on bilateral trade are detailed in B. Bahree, "Bilateral Trade Accords are Blasted by Head of GATT in Appeal for Unity," *Wall Street Journal*, 20 August 1981, p. 34.

[5]Specifically, the Swiss formula called for a tariff rate x to be reduced to a lower rate z, according to the formula, $z = 4x/(x+14)$. This formula would result in larger percentage cuts for higher rates. There was no historical or intellectual reason for the choice of this particular formula. It was chosen principally because it was simple and implied an acceptable cut in the average tariff levels.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

sense, tariff reductions on average would have been 41 percent for the United States, 43 percent for the EEC, 68 percent (in applied rates) for Japan, and 39 percent (in applied rates) for Canada.

Failure of the United States and other countries to meet the tariff reductions dictated by the Swiss formula created a general environment of tariff reduction avoidance. When concessions were made for one country, other countries felt it in their best interest to protect themselves by maintaining higher tariffs on items of particular sensitivity in their countries. Agreements affecting nontariff barriers were reached in three major areas: codes for conduct of international trade, reform of the GATT framework, and the reductions of nontariff barriers in specific products.

Six codes were agreed upon in Geneva. They addressed such trade problems as government procurement, the use of export subsidies, the imposition of countervailing duties, "dumping" of goods in foreign markets, customs valuation, the setting of standards for imports, and the issuance of import licenses. In addition, two other codes were discussed but no agreement was reached. GATT allowed countries to protect themselves against import surges in order to safeguard domestic industries. But increasingly, major industrial nations ignored the GATT mechanisms and used bilateral negotiations that allowed countries to "voluntarily" limit their exports of industry-threatening products.

Recent Developments

In March 1979, the U.S. International Trade Commission determined that Korean bicycle tires and tube imports were injuring domestic producers.[6] In October, the ITC recommended that President Carter impose three years of quotas on Russian anhydrous ammonia. In November, the commission proposed a sharp increase in U.S. import duties on low-priced porcelain and on steel cookware. By late spring of 1980, pressure was building to impose significantly higher import duties on small trucks imported from Japan. In August 1980, that pressure resulted in a 25 percent duty on lightweight truck chassis originating in Japan.[7]

A significant increase in the use of trade restrictions as a foreign policy weapon was witnessed in 1980.[8] In response to the Soviet

[6]See "U.S. Ruling Faults Imports of Korean Bicycle Tires," *Wall Street Journal*, 23 March 1979, p. 36.

[7]See A. Pasztos, "Sharp Boost in Duties on Foreign Trucks is not Expected to Aid Sales of U.S. Models," *Wall Street Journal*, 20 August 1982, p. 9.

[8]Support for these actions can be found in F. Allen, "Executives Say Imports Pose Serious Threat," *Wall Street Journal*, 27 August 1980, p. 11.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

invasion of Afghanistan, the United States forbade domestic exporters to sell corn, wheat, and certain fertilizer products to the Soviet Union. Severe restrictions also were placed on the export of high technology products.

In the summer of 1980, Ford Motor Company joined with the United Auto Workers to petition the ITC to grant protection from import competition from Japan. The U.S. International Trade Commission determined that imports were not a substantial cause of the domestic auto industry's sales problem. But Congress and the executive branch responded to political pressure and "voluntary" export restraints were discussed with the Japanese government. In effect, the Japanese automakers agreed—under pressure from the Japanese government—to restrict exports to the United States to 1.68 million units in the year following April 1981, and not to increase their exports unless the U.S. sales of all autos expand. Currently, Japanese auto company spokesmen are indicating reluctance to abide by the voluntary restraints. Thus the stage is set for yet another round of calls for tighter protection from U.S. automakers and labor organizations.

Although the Reagan administration endorses free trade, it is considering a new trade policy based on "reciprocity." The goal is to force other industrial nations to reduce their trade barriers to American-made goods and to reduce subsidies to their export industries. If a nation fails to meet these conditions, special restrictions and/or tariffs conceivably would be imposed on its exports to the United States.

The approach represents a radical change in U.S. trade policy. In essence, it is a bilateral framework that requires negotiations with all countries that trade with the United States before extension of the U.S. most-favored-nation (minimum) tariff structure. This policy would represent an abandonment of the unconditional most-favored-nation principle that has been the foundation of trade policy among the industrial nations since 1923. As such, it invites increased protectionism among the industrial countries, and threatens a return to the "beggar-thy-neighbor" policies of the early 1930s.

The move toward protectionism got another push when the domestic steel industry on January 11, 1982, filed forms with the Commerce Department and the International Trade Commission charging nine European countries, Brazil, and South Africa with unfair trade practices. In its preliminary rulings, the Commerce Department found that nine foreign governments had been unfairly subsidizing steel exports. The International Trade Commission agreed that 90 percent of the unfair trade complaints represented reasonable injury to

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

domestic steel products. The Commerce Department's final ruling reduced most of the subsidy margins cited in its preliminary determination and narrowed the list of offenders to six Western European countries.

On October 21, just hours before the Commerce Department would have been required to impose countervailing and penalty duties—selective increases in U.S. tariffs and duties—quota negotiations were finalized limiting European steel imports to about 85 percent of 1981 levels. In addition, the quotas were extended to pipe and tube products. The accord has two parts:

1. Carbon and alloy steel shipments will be limited to an average 5.44 percent of the projected U.S. market. The pact also sets individual ceilings for specific categories. The Europeans will set up a new export licensing system to enforce this part of the accord.

2. Pipe and tube exports will be restricted to 5.9 percent of expected U.S. demand. If it seems likely that the limit will be breached, the two sides will have 60 days to find a settlement. Otherwise, either may impose new restrictions.

The United States will help enforce the agreement by invoking a newly enacted law that allows the customs service to block specified steel imports that have not received foreign export licenses. Such actions could undercut U.S. efforts to persuade the Western Europeans and Japanese to move toward freer trade by dropping some nontariff barriers.

Restrictions on U.S. exports to the Soviet Union and U.S. efforts to curtail East-West trade in the aftermath of martial law in Poland also threaten to disrupt trading patterns that have been established during the past 10 years. That, too, will detract from economic growth both in Western Europe and Japan, increasing economic tensions among the industrial countries.

With record trade deficits persisting, implementation of the new GATT codes of conduct only beginning, and unemployment rates in the United States near their postwar high, pressure will be intense to protect American industries, from autos and steel to textiles and footwear. The influence of the protectionist groups is fairly apparent in the various trade legislation currently on Congress' agenda. The influence of protectionist groups is felt both in the formulation of protectionist legislation and free trade policies. An example of the push for protectionism on Capitol Hill is the local content legislation that is aimed at largely eliminating Japanese auto imports. Protectionist influence is also evident in the supposedly "free trade" type

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

of legislation such as the Carribean Basin Initiative. This legislation would reduce trade barriers for numerous commodities but retain protection for textiles and sugarcane—commodities in which the Carribean region has a clear comparative advantage.[9]

The November 1982 GATT Meeting. In November 1982, for the first time since 1973, a GATT ministerial meeting was held. The following major issues appeared on the GATT agenda:[10]

1. A moratorium on protectionism, designed to stem the proliferation of new trade barriers;
2. A new safeguards system that would limit the import restraints a country may impose to protect industries threatened by foreign competition;
3. Extension of the GATT rules to cover trade in services, investments, and high-technology products;
4. Common Market subsidies on agricultural exports;
5. A proposed round of negotiations between rich and poor countries aimed at opening the developing countries; and
6. The development of a dispute-settling mechanism.

One of the objectives of the meetings was to reassure the world that the major trading countries would resist the kind of protectionism that could result in a worsened worldwide recession. However, due to the disagreement among member countries, the meetings were doomed to failure.[11] Even the GATT director doubted that much agreement could be reached on the major issues, such as import safeguards.[12]

At best, the results of the ministerial meeting can be considered a symbolic victory for free trade. The member countries committed themselves in principle to avoid further violations of GATT rules and to correct existing ones. The document, however, lacks any new measures to reinforce that pledge.[13]

[9]See G. Sieb, "Reagan Sends Caribbean Plan to Congress," *Wall Street Journal,* 18 March 1982.

[10]For a more detailed account of the basic issues, see A. Pine, "Ministers Mull World Trade," *Wall Street Journal,* 11 November 1982, p. 6.

[11]See A. Pine, "U.S. Worries that . . . GATT Parley Will Increase Protectionism not Trade," *Wall Street Journal,* 5 November 1982, p. 36; and idem, "GATT Talks Face Problems as Negotiators Fail to Agree on any Big Issue on Agenda," *Wall Street Journal,* 10 November 1982, p. 25.

[12]See World Briefs column in the *Wall Street Journal,* 8 October 1982.

[13]See A. Pine, "GATT Meeting Communique Isn't Likely to Have Much Influence on World Trade," *Wall Street Journal,* 30 November 1982, p. 2.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The lack of agreement on the major policy issues discussed at the GATT ministerial session should not be surprising to an economist. The dismantling, as well as the imposition, of trade restrictions alters the incentive structure of different interest groups in the member countries. The restrictions clearly increase the well-being of some the poor member countries. However, to the extent that the restrictions do not benefit the world as a whole, countries negatively affected will either try to circumvent the regulations[14] or lobby for more favorable restrictions.[15]

Trade restrictions give rise to economic rents. This is turn gives rise to rent-seeking behavior. To the extent that those countries that benefit from the actions can organize effectively, the political process may result in protectionist policies.[16] Thus one of the problems for advocates of free trade is to keep protectionist pressures within bounds and to avoid repeating the experience of the Smoot-Hawley Act of 1930.[17]

The Williamsburg Summit. Recent developments are not encouraging to those who advocate free trade. At first glance, the trade restrictions of high tariffs and new quotas on specialty steel and an effective increase in tariffs on frozen concentrated orange juice from Brazil seem too superficial to be concerned about. But a close look reveals that the threat posed by these restrictions is potentially far more than a mere blemish on the economic recovery of the world economy. The actions suggest a retaliatory behavior on the part of the United States. The view becomes more credible as one takes into consideration the fact that the countries affected were the

[14]For an analysis of individual behavior and smuggling activity in the presence of trade restrictions, see J. N. Bhagwati and B. Hansen, "A Theoretical Analysis of Smuggling," *Quarterly Journal of Economics* 87 (May 1973): 172–87; J. N. Bhagwati and T. N. Srinivasan, "Smuggling and Trade Policy," *Journal of Public Economics* 2 (November 1973): 377–89; and R.E. Falvey, "A Note on Preferential and Illegal Trade under Quantitative Restrictions," *Quarterly Journal of Economics* 92 (February 1978): 175–78.

[15]For a discussion of the politics of special interest groups, see W. A. Brock and S. P. Magee, "The Economics of Special Interest Politics: The Case of the Tariff," *American Economic Review* 68 (May 1978): 246–50.

[16]Analysis of rent-seeking behavior can be traced to A.O. Krueger's seminal paper. "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June 1974): 291–303. Krueger's analysis has been further refined and generalized by J. N. Bhagwati and T. N. Srinivasan, "Revenue Seeking: A Generalization of the Theory of Tariffs," *Journal of Political Economy* 88 (December 1980): 1069–87.

[17]On this issue, see R. Straus, "The Mercantilist Threat to World Trade," *Wall Street Journal,* 24 November 1982.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ones opposed to the major issues discussed at the November 1982 GATT meeting.

The decision by the president to provide protection to the specialty steel industry, little more than a month after the May 1983 Williamsburg economic summit, undercuts the U.S. efforts to ease trade barriers among the industrialized countries. To add insult to injury, the new restrictions on steel—ranging from higher tariffs on stainless steel sheet strips and plates to quotas on stainless steel bar and plates, and alloy tool steel products, which reduce imports by as much as 44 percent below their 1982 levels—fall largely on six industrial nations: Canada, France, West Germany, Italy, Japan, and the United Kingdom.

Administration arguments that the new trade restrictions are designed to foster the goals of the Williamsburg summit by pressuring other nations to get rid of practices injuring U.S. producers are fatuous. The European response was to threaten to retaliate with higher tariffs on U.S. exports to the Common Market. Furthermore, the U.S. actions ignore recent European moves reducing "unfair" trade practices. Prior to the economic summit, the Common Market countries had agreed to phase out, over the next 18 months, the steel subsidies that are so offensive to U.S. producers and the administration. Yet, the higher tariffs and quotas will prevail for four years.

Effect of Trade Policies on the U.S. Economy

Sectoral Impact of Trade Policies

This section presents two case studies analyzing the effectiveness of trade policies used to aid a domestic industry. First, the apparently successful case of temporary import restraints on color televisions is explored. Next, the more complex, and apparently unsuccessful, attempt to assist the domestic steel industry adjust to foreign competition is presented.

Color Televisions. In the spring of 1977, the United States negotiated an orderly marketing agreement with Japan that reduced the number of Japanese color television imports into the United States to 1.56 million units from their high of 2.5 million units reached in 1976.[18] The Japanese producers more than complied with these restrictions, reducing exports to the United States to 1.4 million units in 1978.

[18]A more detailed analysis of the effects of the orderly marketing agreement can be found in V. A. Canto and A. B. Laffer, "The Effectiveness of Orderly Marketing Agreements: The Color TV Case," *Business Economics* 18 (January 1983): 38–45.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

U.S. producers, however, did not benefit from this restriction. Instead, foreign producers (especially in South Korea, Taiwan and Canada) increased dramatically their exports to the United States. As a result, color television imports in 1978 were above their 1977 level and nearly as high as their record 1976 level. The sudden success of these foreign producers led to new or extended import quotas for Taiwan and South Korea. As a result, total color television imports in 1980 were 1.3 million units, less than half of their 1976 peak.

The apparent success of the effort to protect the domestic color television manufacturers is misleading. Domestic producers (both U.S. and foreign-owned) circumvented these restrictions by beginning the production of their televisions in the United States, exporting the incomplete sets for the bulk of the manufacturing and assembly, and then "reimporting" the televisions for final assembly in the United States. The tariff imposed on the "reimported" TVs is only 5 percent of the foreign value added.

During the 1977–80 period, incomplete color TV imports rose to nearly three million units from virtually zero in 1976. Subtracting these from total "U.S.-produced" TVs indicates that the domestic production of color TVs has increased only slightly since the imposition of the trade restrictions. Moreover, since 1977, the number of persons employed and the average number of man-hours worked in the domestic industry have declined.

Steel.[19] In response to the steadily growing market share of Japanese steel imports, the United States in 1968 negotiated a three-year voluntary restraint agreement with Japanese and European exporters. Exports of steel to the United States were limited to a target of 14 million tons in 1969—22 percent below their 1968 level. The target was allowed to increase gradually during the subsequent years. And the agreement was extended in 1971 for three additional years.

In the face of the quantity restriction, the Japanese and European exporters shifted their product mix from lower-valued steels—where they had made the largest inroads—to higher-valued products. During the six years of the import restrictions, domestic prices of higher-valued steel products, such as cold- and hot-rolled steel, remained fairly close to those of the Japanese. The price of lower-valued steel products, such as structurals, however, increased well above the

[19]The analysis in this section is based on V. A. Canto, R. V. Eastin, and A. B. Laffer, "Failure of Protectionism: A Study of the Steel Industry," *Columbia Journal of World Business* 17 (Winter 1982): 43–57.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

world price. As a result of this shift, even though the tonnage of steel imports was reduced, the overall value of imports remained approximately the same.

The net effect of increased competition in higher-valued steels and less competition in lower-valued steels was, if anything, to hurt the U.S. steel industry. The rate of return of the industry during the period of import restrictions (1969–74) was lower than during the three years prior to the period of import protection and the two years subsequent to import protection. During the protected period, capital expenditures in constant dollars declined relative to 1967 as well as to the years subsequent to the expiration of the voluntary restraint agreements. Moreover, the voluntary import restraints did not stop the decline in the steel industry's employment levels.

Trigger prices, too, have been unsuccessful in fostering a healthy, domestic steel industry. The trigger prices have been successful in reducing the market share of steel imports from Japan and the European Economic Community. But the bulk of this gap has been filled by imports from other foreign producers. Moreover, the trigger price mechanism acts to increase the profit margin of foreign producers as soon as it becomes effective. As such, it provides them with an incentive to increase their production, even if sold at prices below the trigger and prevailing market prices. This distortion of incentives can be expected to lead directly to an increase in the incidence of dumping charges by U.S. producers.

The 1950-to-1983 experience of the U.S. steel industry can be explained largely in terms of the standard trade theory without any reference to government interference in world steel markets. Following World War II, as Japan rebuilt its steel industry, resulting in larger and more efficient plants, the cost advantage of producing steel shifted from U.S. producers to Japanese producers. The steady loss of market share by U.S producers is, to a large extent, due this shift in cost effectiveness.

In January 1982, major U.S. steel companies sought relief from government-subsidized competitors. As a result of these legal actions, the U.S. government dropped enforcement of the trigger price mechanism. Preliminarily in June and finally in late August, the Commerce Department upheld charges of government-subsidized steel prices against six Western European nations. Under the law, high tariffs in the form of countervailing and penalty duties would have been levied to offset the advantages of foreign subsidies and dumping. In their stead, the Commerce Department negotiated quotas on European steelmakers. Individual ceilings for specific categories also were set.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The Impact of Trade Policies on the National Economy

Import tariffs and export subsidies represent another set of policies attempting to improve the balance of trade. Advocates of these policies observe that tariffs raise the domestic prices of imported goods and subsidies reduce the prices of exported products to foreigners. This reduction in imports and the stimulus to exports are believed to improve the balance of trade and, consequently, domestic economic conditions.

An analysis of the effects of changes in average tariff rates on the trade balance, however, indicates that the real-world effects of tariffs on the balance of trade are more complex. Not only do tariffs reduce imports but they are associated with a decline in exports as well. Thus, the impact of tariffs on the trade balance is ambiguous (with the exception of the extreme case in which a country is running a trade balance deficit and then bans all imports). The decline in exports and imports indicates that the overall volume of trade is reduced by tariffs. Moreover, since both exports and imports are reduced by import tariffs, the trade balance (exports less imports) would be little changed. This result can be understood by realizing that exports and imports are two sides of the same transaction: The object of producing goods for export is to be able to import and consume goods produced by foreigners.

Suppose that a tariff successfully reduces the volume of imports by one-half. There are now only half as many foreign goods available to exchange for domestically produced goods, given the world terms of trade. So, the volume of exports must be reduced symmetrically by one-half. The net effect on the trade balance is zero. In other words, a tax on imports is equivalent in effect to a tax on exports. This principle is referred to as Lerner's symmetry theorem, a well-known principle of trade theory.[20]

Quantitative restrictions in the form of import quotas and self-imposed foreign export quotas also are on the menu of protectionist policies. In principle, there is a precise correspondence between quotas and tariffs: For any quota (or quantitative restriction) imposed, there exists a tariff that will produce exactly the same price and quantity effects on the volume of imports and exports. The Lerner symmetry theorem is equally applicable to quotas. A restriction on imports is equivalent to a restriction on exports and can be expected to have little or no effect on the balance of trade. Thus, the efficacy

[20]A.P. Lerner, "The Symmetry between Import and Export Taxes," *Economica* 3 (August 1936): 306–13.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

of protectionist measures to improve the trade balance is dubious on both theoretical and empirical grounds.

Trade restrictions reduce the efficiency of the world economy and reduce the standard of living of all trading partners.[21] To the extent that trade restrictions are effective, the gains from trade in both production and consumption are lost. Production incentives shift away from those goods that are produced more efficiently domestically. And consumers are no longer able to choose goods produced more efficiently abroad. Trade restrictions devised to protect a particular industry may well accomplish that task for a period of time. But the cost of protecting that industry is borne by the rest of the economy.

Further, tariffs and quotas on imports constitute tax wedges for the world economy. With fewer goods available in each domestic economy, at higher prices, the rewards for work effort are reduced. The Smoot-Hawley Act tariffs offer grim evidence of the tax wedge imposed by tariffs.

Conclusion

The increase in protectionist legislation and the Reagan administration's new trade policy based on "reciprocity" represent a departure from the postwar trade liberalization movement. The administration hopes to convince other nations to lower their trade barriers and to reduce subsidies to their export industries. In order to achieve these objectives, the United States stands ready to increase its trade barriers on a bilateral basis and increase subsidies to its import-competing industries. This policy is supposed to be sufficient to further the goal of freer world trade.

The policy issue therefore centers on whether judiciously applied protectionist measures can contribute to domestic economic stability and growth. In particular, can instruments of trade policy be used to improve a country's balance of trade and its overall economic performance? Furthermore, can specific industries suffering from import competition be assisted through protectionist measures, thereby reducing unemployment and increasing total output and income?

The grim experience of the early 1930s amply demonstrates that the movement toward protectionism carries with it major implications for the U.S. economy. Virtually all economists and policy makers agree that, in the extreme, trade restrictions are self-defeating, impoverishing foreign countries and U.S. citizens alike.

[21]See V. A. Canto, A. B. Laffer, and J. C. Turney, "Trade Policy and the U.S. Economy," *Financial Analyst Journal* (September/October 1982): 237–46.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

PROTECTIONISM AND THE U.S. ECONOMY

Sidney L. Jones

Introduction

It is obvious that the world economy has become highly integrated in terms of international monetary, trade, and investment relations. The integration continues to increase despite the disruptive effects of economic nationalism, supply-side oil and crop shocks, military destruction and cold war tensions, and extensive geopolitical manipulation. Most nations, including the United States, have benefited from this integration, fulfilling the positive expectations of economists that the overall wealth of nations is enhanced by pursuing specific areas of comparative advantage (or minimal disadvantage) and then liberally exchanging goods and services. U.S. merchandise exports and imports have grown rapidly during the last decade: 1971 exports of $43 billion rose to $236 billion by 1981, before an unexpected decline in the volume of world trade in 1982, and imports jumped from $46 billion to $264 billion during the same ten-year period. These trade totals are relatively small compared to a total gross national product of approximately $3 trillion, but the rapid growth is impressive and it should be emphasized that foreign trade is very important to American farmers and manufacturers, and of increasing significance to our service industries. The revival of international trade is now a crucial element in reversing the extended economic recession that has seriously disrupted the world economy.

Despite the important benefits created by expanding international trade and investment, our current policy dilemma is the most serious since the 1930s, when widespread restrictions disrupted political, social, and economic stability and contributed to the devastating

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Resident Scholar at the American Enterprise Institute, Washington, D.C. 20036.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

world war. Trade policy problems are now comparable to the deteriorating monetary conditions that developed during the late 1960s, when fundamental economic distortions and repeated government interventions eventually caused the Bretton Woods system of fixed exchange rates, based on the role of the U.S. dollar, to collapse during the summer of 1971. Current trade policy issues appear to be at a similar turning point: (1) The international rules of conduct established in the early postwar era during extended GATT negotiations are increasingly swamped by the realities of competition and an ominous shift toward protectionism and excessive economic nationalism; (2) the escalation of abrasive trade problems is seriously disrupting fundamental international political and security relationships; and (3) the current distortions will likely become worse before they are corrected.

The paper by Professor Canto properly emphasizes the movement toward trade distortions caused by the proliferation of nontariff barriers, even though tariffs have been significantly reduced by occasional multinational GATT procedural negotiations.[1] The political responsiveness to special interest groups demanding short-term assistance in the form of protective tariffs, import quotas, export subsidies, nontariff barriers, investment restrictions, capital exchange controls, cartels, and geopolitical economic sanctions is recognized as a threat to the long-term benefits of an open and competitive international trade and investment system. The fundamental problem continues to be the difficulty of comparing the benefits of expanding foreign trade and investment, which are diffused throughout the entire economy, against the specific costs of competition from foreign sources.

The immediate challenge is to sustain support for the somewhat abstract principle of an open and competitive system despite specific distortions. The degree of actual public support for this principle typically falls well below the level assumed by most economists and tends to fluctuate in direct response to changing conditions of domestic economic growth and unemployment. While the world has avoided an all-out trade war, which would return us to the unfortunate conditions of the 1930s, it is naive to assume that the familiar arguments in favor of increasing foreign trade and investment are universally accepted, particularly during periods of unusual domestic unemployment and geopolitical tensions.

[1]Victor A. Canto, "U.S. Trade Policy: History and Evidence," *Cato Journal* 3 (Winter 1983/84): 679–96.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Even when the general principle is accepted there is considerable disagreement about what strategic and tactical policies to use. Part of the growing skepticism about the effectiveness of traditional American policies represents normal political responses to specific constituencies and near-term election schedules. But another factor involves the historical failure of economists to convince politicians and the general public that significant *net advantages* justify continued reliance on an open and competitive economic system, and that the explicit costs and potential risks require specific policy and operating adjustments rather than generalized protectionism.

The large gap between the theories of international trade and investment and the realities of our domestic political economy is typical of the market system. Most Americans, particularly our business and government leaders, are not particularly impressed by theories. Policies and institutions that work well are perpetuated; those that do not perform as expected are quickly discarded. This attitude is prevalent in foreign trade activities where American companies have traditionally concentrated on the domestic market and only sporadically turned to external markets to utilize unused capacity or exploit technological and marketing comparative advantages. As the world has evolved into an integrated economy, this casual approach has failed to develop and sustain a comprehensive trade policy that adequately responds to our diverse political, social, economic, and security goals. America has not created a definitive set of guidelines that adequately respond to our diverse interests and reponsibilities. Individual executive departments and congressional committees have been left to work out ad hoc responses to domestic special interest groups and external pressures from other industrial and developing nations. The confusing and contradictory results have created serious problems requiring attention at three different levels of analysis: (1) identification of the current and potential sources of difficulty; (2) agreement on a philosophy for trade policies; and (3) selection of specific strategies.

The Diversity and Changing Mix of Trade Problems

As various trade problems have converged, it is useful to consider the diversity and timing of issues rather than concentrating on current controversies, such as steel, agricultural products, high-technology goods, and pipeline equipment. A comprehensive approach is needed to avoid an uncoordinated series of responses to specific interest groups as priorities and conditions change. Recognizing the diversity of cyclical and structural problems, supply-side shocks, and

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

geopolitical trade distortions is the beginning point for trying to identify coherent national policies.

Cyclical Problems

The extended international economic recession has created historically high unemployment in most industrial and developing nations, triggering intense pressures for trade protectionism to preserve domestic industries and jobs based on questionable "beggar-thy-neighbor" assumptions that actually increase stagnation problems. Some of these distortions will be alleviated as the anticipated cyclical recovery accelerates.

Structural Problems

The impressive postwar recovery of Western Europe and Japan and the rapid emergence of many new industrial nations has increased competition for world export markets. The U.S. share of world trade will continue to be eroded, even though the absolute amount of foreign sales will rise if the international economy revives, and many specific industries will experience a difficult transition. Structural problems have developed as nontariff barriers have increased and discriminating trading blocs have been created to promote regional political and economic interests.

Supply-Side Shocks

The oil shocks (1973–74, 1979), the large appreciation of the U.S. dollar since mid-1980, occasional world crop disasters, and many other real and contrived raw material shortages have seriously disrupted international economic relations, particularly trade patterns. The recent economic recession, and its continued impact in many foreign countries, apparently eroded the power of OPEC and other cartels, but there is still an unfortunate trend toward arbitrary trade restrictions.

Geopolitical Distortions

Despite many persuasive theoretical arguments, and abundant empirical evidence concerning the ineffectiveness of economic sanctions as a tool for directly changing the political and military behavior of other governments, the United States continues to frequently use trade and financial sanctions to punish adversaries as part of its geopolitical policies. The disjointed nature of the sanctions used has confused foreign governments and domestic manufacturers and farmers. When such sanctions have been used, other sources have typically supplied the goods and services, resulting in the loss of

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

important markets for American exports. The sanctions have usually been reversed after a relatively brief period of time, but the domestic economic injury has persisted and foreign sales have been lost. The use of sanctions has demonstrated U.S. antagonism and symbolized important national principles, but there is considerable evidence that the economic injuries inflicted have not changed the geopolitical behavior of the target nations.

Ambiguous Trade Policies

U.S. trade policies historically have not been based on any clear and firm commitment to the role that trade is supposed to play on a sustained basis. Most economists favor "free trade" principles and individual businessmen and government officials have attempted to promote trade, but the necessary clarity of national goals and supportive policies and procedures has not been developed. To become more comprehensive, beyond the familiar concepts of commercial profits and balance-of-payments benefits, future trade policies must consider broader national goals—political, social, economic, and military security. Until our overall national interests are better defined, we will continue to muddle along relying on the rhetoric of free markets as a general guideline, but sporadically turning to restrictive trade practices whenever such actions seem to serve the immediate interests of the government and powerful special interests.

Identifying National Trade Philosophy

The United States has traditionally followed a policy of benign neglect with regard to trade policy issues because of the dominant influence of domestic markets on the plans of domestic companies, a philosophical aversion to government intervention in economic activities, and a general absence of organizational skills in developing consistent and sustained procedures. Most government and business leaders continue to advocate an idealized version of a competitive market economy (even though their actual behavior too often calls for government financial assistance and special protection). When American exporters and importers attempt to enter the world markets, however, they usually must deal with state-controlled buying and selling organizations or competitor firms that receive advantageous government aid and protection. Most nations have not adopted our economic model and are unlikely to do so during the foreseeable future despite the demonstrated advantages of an open and competitive economic system.

In preparing to compete in this type of world economy, an explicit decision is required concerning the proper role of government. There

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

are several possibilities, each with its own implications for U.S. trade policy:

- An aggressive role, with government encouragement, subsidies, and adjustment of regulations, controls, taxes, and research activities to promote exports and discourage imports.
- A passive role, with private American companies and farmers responsible for solving their own problems.
- A defensive role, with government responding to discrimination against U.S. interests; one example would be support for current legislation calling for trade reciprocity to promote "fair" trade as distinguished from "free" trade.

The difficulty of identifying a distinct U.S. trade philosophy is that attitudes shift all the way along the spectrum in response to special interests, external trade pressures, and cyclical conditions. The framework of policies in other nations appears to be more formalized and stable. It must also be recognized that businessmen must have a consistent attitude with regard to government intervention; that is, if the government is expected to play an aggressive role, there may be additional regulation and public planning even though most businessmen would object to this type of intervention as distinguished from the helpful forms of preferential treatment.

Policy Strategies

After identifying the diversity of trade problems that must be responded to and selecting a consistent philosophy to clarify goals, the next step is to develop a strategic approach. Five different approaches could be taken, ranging from completely free trade to comprehensive government planning of U.S. trade policy:

1. Hands-Off Approach—absolutely no government interference or assistance in the sale and purchase of goods and services in foreign trade.
2. Modified Market Approach—same philosophy, except for limited controls over "strategic" goods and services and in cases involving health and safety issues; grant national treatment to foreign goods and services and expect all U.S. laws and taxes to be honored.
3. Case-By-Case Approach—continue the present practice of allowing the Executive Branch and Congress to change the rules for specific countries and different goods and services whenever it seems to serve a current political, social, economic, or security interest.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

4. Geopolitical Approach—explicitly admit that trade and investment rules will be manipulated to reward and punish other nations for their political and military support or antagonism.
5. Economic Warfare Approach—use trade and investment rules to mount an organized attack on political and military enemies.

Throughout the postwar era the policy strategies have shifted over the entire spectrum. At this time the United States appears to be using the case-by-case approach involving a basic free trade orientation mixed with specific marketing orders and voluntary agreements with other nations to limit their exports. This approach clearly reflects a responsiveness to special interests during a period of considerable economic difficulty. Those who favor a more open and competitive system criticize this strategy, but its advocates argue that such compromises are necessary to avoid a more widespread rejection of trade and investment exchanges favored by protectionist interests.

Conclusion

Trade policy issues will continue to become more important in the future world economy. Professor Canto's paper describes some disturbing trends that deserve attention. In the political environment it will always be difficult to achieve the level of free trade and investment principles that most economists favor, but such studies should help focus attention on the risks of allowing protectionism to expand. The current cyclical recovery in the United States may alleviate some of the protectionist pressures while the rest of the world waits for an improvement in global economic performance. In the interest of promoting economic growth, however, special emphasis should be placed on studying the range of trade problems, the proper philosophy to be followed, and the specific strategies to be followed.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

DO TRADE DEFICITS MATTER?

Paul Heyne

Introduction

Some things matter whether or not they exist. The Loch Ness monster is one. National trade deficits are another. Trade deficits obviously matter to many people, because (whatever they are) they seem to have significant consequences. They cause problems or create undesirable constraints or compel government policy changes.

It is often extraordinarily difficult, however, to determine the precise consequences of trade deficits, real or alleged. The current U.S. trade deficit, if we have one, provides a good example. Are the problems supposedly associated with it the *causes* of the deficit or its *effects*? One reason we cannot answer that question might be that we cannot agree whether the deficit is already here or merely impending. Has the United States been running a continual trade deficit since 1975, as some reports would have it? Or are we only on the way toward a deficit, as a consequence of our current economic recovery and the lagging recovery of our principal trading partners?

Both claims are made and published. Those who report to alarmed readers that the United States has run a trade deficit in every single month over the past seven years almost never stop to reconcile this "fact" with the equally well-established "fact" that U.S. exports of goods and services exceeded imports from 1976 through 1982 by an annual average of almost $13 billion.[1] How can a $90 billion surplus be accumulated by running deficits each and every month?

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Lecturer in Economics at the University of Washington, Seattle, Wash. 98195.

[1]In this paper all data on U.S. international transactions are based on the standard Department of Commerce calculations, as reported in numerous official publications. See, for example, the International Statistics section in the monthly issues of *Economic Indicators*.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The explanation, of course, is that the monthly "deficits" are the difference between merchandise exports and imports, while the annual "surpluses" are the difference between exports and imports of merchandise plus services. Now it is essential that the phrase "of course" appear in the above explanation, to avoid any implication that I think I am saying something new or profound by calling attention to the difference between the merchandise trade balance and the balance on goods and services. After careful reflection, however, I want to withdraw the phrase. Let the first sentence of this paragraph stand unblushingly stripped of its fig leaf.

It is quite possible that nothing at all in this paper is new or profound. That in fact is exactly how it appears to me. The entire essay seems to me to be a series of fairly obvious assertions. If I am going to start saying "of course," therefore, I will have to do an awful lot of it, and that would quickly grow tiresome. More importantly, it would disguise the essential point I want to make, which is that we are not thinking carefully or communicating responsibly when we talk about trade deficits. I am therefore going to omit the defensive "of course" in everything that follows, and try instead to be clear. It might even happen that, if I make my position unmistakably clear, some critic will be able to rescue me from error, and show me why those who speak of trade deficits are in fact making sense, not wandering in darkness and confusion.

It isn't only backwoods editors or small-town journalists who treat deficits in merchandise trade as if they were more than they are. The *Wall Street Journal* and the *New York Times* frequently report the Commerce Department's monthly merchandise trade figures in a language of alarm, offering no hint to the reader that the deficits result from a partial accounting.[2] The government's recent forecast of a more than $100 billion merchandise trade deficit for 1984 was referred to by the *Journal* as "a red-ink total." If they do these things in a green tree, what shall be done in the dry? So let us return to fundamentals to see if we can first agree what it is we are talking about.

We should all be able to agree that any report of a deficit or surplus in a nation's total international transactions is necessarily based on a partial accounting of some sort, for the simple reason that all international economic transactions are treated as exchanges, in which, for accounting purposes, the value of whatever is given up is exactly equal to the value of what is obtained in return. Consequently, the

[2]Readers who want to sample these reports should see the newspapers on the 29th day of any month.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

balance of payments always and necessarily balances. If the flow of measured exports exceeds or falls short of the total of measured imports, measuring errors must have occurred—as they are bound to do in any attempt to keep track of the international transactions of 230 million people. The record keepers consequently add the difference to the smaller of the two flows and label it "statistical discrepancy."[3]

It follows from this that any announcement of a deficit or surplus in a nation's foreign transactions results from a decision *not to count certain transactions*. Which ones? And why are they excluded? In order to see what might be going on here, we must first turn our attention to one of the most useful and simultaneously most misleading concepts in economics, the concept of *equilibrium*.

The Concept of Equilibrium

In economic theory, an equilibrium situation is a situation of balance among contending forces. It is a stable situation, in the sense that it can be expected to persist as long as all the contending forces retain their present form. The crucial point to be noticed is that *equilibrium is a concept*, not something that can be observed empirically. Any and every constellation of economic variables is an equilibrium constellation *from some point of view*. After all, any actual situation must be the result of a balance among contending forces, however momentary that balance may be. And every imaginable situation will be an "equilibrium" if we imagine the appropriate circumstances.

The point is much easier to make with concrete examples.[4] Let's take the common textbook case of government price supports and an equilibrium price for corn. Although economists frequently characterize the equilibrium price as "the price that clears the market," this cannot be a correct definition since *the market clears at every price*. The quantity of corn purchased is always equal to the quantity sold, whatever the price, because purchases and sales are opposite sides of the same coin.

"Wait a moment," an economic theorist will object. "The quantities purchased and sold are not the same thing as the quantities demanded

[3]The statistical discrepancy in recorded data for the United States came to $42 billion in 1982, an amount that swamps any defensible measurement of a deficit (or surplus) for the year. I do not know why this bit of news has so little effect on those who anxiously report on the shifting course of deficits and surpluses.

[4]My argument in this section has been extensively influenced by the perceptive analysis in Steven N.S. Cheung, "A Theory of Price Control," *Journal of Law and Economics* 17 (April 1974): 53–71.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

and supplied. It's quite true that purchases will exactly match sales; but sellers might *want* to sell more than purchasers are willing to buy. The quantity supplied at the going price, in other words, might be greater than the quantity demanded at that price—which is what we mean by a disequilibrium. The market only clears when the quantity that demanders *want* to purchase matches the quantity that suppliers *want* to sell."

But notice what this argument implies. It tells us that some demanders or suppliers are behaving differently from the way they want to behave. Isn't that rather odd? If the suppliers of corn want to sell more than they are actually selling, why don't they do it?

"They can't," our hypothetical theorist replies, "because the price is too high."

Then why don't some corn suppliers offer to sell at a slightly lower price, which is what we would predict if the corn suppliers really do want to sell more corn than buyers want to purchase?

"Suppliers don't have any incentive to lower their price," is the rejoinder, "as long as the government stands willing to purchase at the support price all the corn suppliers want to sell at that price."

End of the argument. An equilibrium price for corn, it now emerges, is the price that would clear the market in the absence of a government price support program. It is the price that equates the quantity supplied with the quantity demanded when we exclude from consideration the demand stemming from the Commodity Credit Corporation.

If every situation is taken to be an equilibrium situation, the concept of equilibrium is useless. The usefulness of the concept hinges, therefore, on our ability to specify and distinguish disequilibrium situations. We do this by isolating and excluding some of the forces supposedly at work in the situation under analysis. In the case just argued, the government's demand was excluded in order to focus attention on the factors causing the amount of corn in storage to rise or fall. The exclusion is justified by the purpose it serves. The danger is that we may forget about the purpose that led to the exclusion which defined the disequilibrium, and start pretending that the government-supported price is "really" a disequilibrium price. That's simply nonsense.

Consider another example. Economists frequently claim (I have done it myself) that legislated price controls create shortages by preventing prices from moving to their equilibrium levels. But what do we mean by a shortage? We do not mean a situation in which there isn't enough for all buyers to have as much as they want,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

because that describes just about every situation. We live in a world where scarcity is the general rule. When economists speak of shortages, they usually mean situations in which demanders are unable to purchase all that they want to purchase *at the prevailing price*.

But that's not really accurate, either. If demanders cannot purchase as much as they would like to purchase, won't they search for ways to accommodate their preferences more satisfactorily? And won't these efforts raise the price that purchasers must pay, until the quantity demanded comes into line with the quantity supplied? In the presence of effective legal controls on the *monetary* price, the adjustment in response to competition among purchasers will have to occur entirely in the non-monetary components of the buyers' opportunity cost. But those components affect the quantity demanded just as surely as the monetary price affects it. When we speak of "the quantity demanded at the prevailing price," we are really talking about the quantity demanded at the prevailing cost of acquisition, which includes all kinds of non-monetary costs.

The economist's claim that price controls create shortages turns out, therefore, to be the claim that price controls lead to increases in non-monetary costs of acquisition. The "disequilibrium" prices produced by price controls are disequilibrium prices only if we exclude from consideration *changes* in non-monetary components of the purchase price. This exclusion is justified by the economist's desire to isolate these changes and to examine their effectiveness, relative to changes in monetary price, in securing mutual accommodation between suppliers and demanders. We see once again that an analytical intention suggested the exclusion which gave meaning to the notion of a disequilibrium.

Every claim of a disequilibrium rests upon an analytical exclusion. It is sometimes important to insist upon this fact, in order to avoid giving the impression that the "problem" with a "disequilibrium" is independent of human purposes. A playground seesaw is in physical equilibrium when a fifty-pound person sits on one end and a two-hundred pound person on the other. Only when we take account of the parties' desire to move up and down can we correctly say that the seesaw is in disequilibrium when the heavy person is on the far end rather than up toward the middle.

With only two parties, intentions or purposes are relatively easy to ascertain; we can therefore usually decide quickly whether or not a seesaw is in disequilibrium and start looking for an equilibrium solution. Can we do the same in the case of an alleged disequilibrium in the balance of international payments?

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Disequilibrium in the Balance of Payments

I think we would be far more suspicious when confronted by any alleged trade deficit if we stopped to realize how much is concealed in such disequilibrium claims. They are often, as Fritz Machlup has argued, disguised political judgments.[5] I happen not to share the horror of political or ethical judgments that is conventionally professed among economists. But *disguised* political judgments are another matter. They violate the imperative of clarity. And lack of clarity in an area where conflicting political interests abound is an invitation to trouble. That is certainly the case when we start talking about trade deficits.

Any claim of deficit or surplus in a nation's trade balance, I have argued, necessarily rests upon a decision to exclude some items when calculating the balance. Which ones? And why are they excluded? We're ready now, after our digression on the equilibrium concept, to suggest an answer. The items excluded will be those which enable the persons alleging a trade deficit (or surplus) to call attention to the problems that concern them.

It must be granted at the outset that most people who talk or write about trade deficits are simply taking over uncritically someone else's definition. They may not know what has been excluded in order to create the deficit; and if they do know, they may have no idea of how the exclusion can be justified. I certainly do not want to be understood as arguing that every journalist, academician, or economist in the Commerce Department is concerned about some particular problem when referring to trade deficits. I am more interested in maintaining that all concepts of a trade deficit harbor concealed concerns and disguised political judgments—concealed and disguised, more often than not, from the very people wielding the concepts.

In the last few years, the deficit most often discussed by the news media has been the merchandise trade deficit. Recorded data indicate that the United States has imported a greater dollar value of merchandise than it has exported in every single month since the end of 1975. But why is that called a deficit? What is significant about the relationship between merchandise exports and imports, taken by itself? I don't know how to answer that question, because I don't think that it has any significance at all, and I don't recall ever encountering an explanation that went beyond vague rhetorical alarms.

[5]Fritz Machlup, "Equilibrium and Disequilibrium: Misplaced Concreteness and Disguised Politics," *The Economic Journal* 68 (March 1958); reprinted in Machlup, *Essays on Economic Semantics* (Englewood Cliffs, N.J.: Prentice-Hall, 1963), pp. 43–72.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

It is often suggested or implied that the growing merchandise trade deficit reveals this country's increasing inability to compete internationally with goods manufactured in other countries. But what does this really mean? The inability of General Motors to persuade motorists to buy its automobiles rather than, let us say, Japanese automobiles, probably constitutes a problem for GM's managers, employees, shareholders, and franchised dealers. But how do we know that this demonstrates an increasing inability of "this country" to compete, rather than the ongoing operation of the principle of comparative advantage?

I have learned from experience how difficult it is to persist in this line of argument and be taken seriously. It is simply "obvious" to many people that the United States cannot prosper if our imports of manufactured goods regularly exceed our exports of manufactured goods—as has supposedly been the case for the past seven years and more. I shall pass by the fact that merchandise is not the same as manufactured goods, that the growth of petroleum imports has had far more effect on our merchandise trade balance over the past decade than the dreaded Japanese have had, and that the United States actually exported a greater value of manufactured goods than it imported in both 1980 and 1981, as well as in 1977 and 1979 if we use customs valuations in our calculations. I shall pass by these facts quickly because I fail to see that anything of inherent significance would have been established even if it were true that U.S. exports of manufactured goods had been below imports for each of the past 10 years.

This is not to deny that U.S. firms have often performed poorly in recent years, or that sizeable sectors of the economy are going to diminish dramatically or disappear if major adjustments do not occur in response to foreign competition. What I deny is that comparisons of aggregate merchandise exports with imports provide any kind of help in describing, diagnosing, or prescribing for this situation.

They do, however, provide political arguments that can be used by people who want protection from foreign competitors or subsidies for their efforts to sell abroad. For the existence of a trade deficit implies that the ratio of imports to exports *must eventually decline*, since no deficit can continue forever. So we might as well get on with it now: Fund the Export-Import Bank, restrict imports from nations that interfere with our exports, slap penalties on foreign firms that are "dumping" in our markets, and face up in general to the fact that free trade is good trade only if it is fair trade.

Trade deficits are politically potent weapons because "everyone knows" that "deficits cannot continue indefinitely." Even the federal

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

government must eventually stop running deficits, or else . . . something fearful will happen. What? Popular opinion is vague about the consequences, but fairly firm in the underlying conviction that "you can't go on running deficits forever."

The truth is that the federal government can indeed go on adding indefinitely to its indebtedness, with no assignable limit. It can spend more than it collects in taxes, even without expanding the money stock, so long as it can collect the difference in loans. And it will be able to borrow just so long as and to the extent that people are willing to loan to it. People will be willing to buy and hold government bonds insofar as they think they will be better off owning government bonds than they would be with alternative assets. When the public displays reluctance to hold all the debt that the federal government must issue in order to finance a current deficit, a slight decline in the purchase price of government bonds quickly secures their cooperation. Consequently, the federal government never does operate "in the red": Total outlays are always matched exactly by total receipts, as long as receipts are defined to include funds raised by borrowing. The concept of a government budget deficit has meaning only insofar as we exclude borrowed funds from the total of government receipts. We might well want to do that, for various analytical purposes. But once again it is the analytical intention that creates the deficit, by specifying what will be excluded from total receipts—which would otherwise necessarily equal total outlays.

For reasons that are unclear to me, this line of argument does not seem to be generally accepted when it comes to discussions about the balance of payments.[6] The data-tenders calculate deficits or surpluses of various kinds with an astonishing lack of attention to what has been excluded in the process. It is no doubt obvious, at least in the Department of Commerce, that the merchandise trade deficit omits services. But to whom is it obvious that something has also been omitted when the data-keepers calculate the balance of trade on goods *and* services? It is not at all obvious, I submit, to some knowledgeable writers for the *Wall Street Journal*, to take just one example.

[6]The *Survey of Current Business* celebrated its 50th anniversary in 1971 with a special issue devoted to a review of the programs of the Bureau of Economic Analysis (then the Office of Business Economics) in the Department of Commerce. Several of the distinguished scholars invited to contribute focused on balance-of-payments accounting. Their comments are illuminating, but they leave the reader—this reader, at least—wondering why the bureau continued afterward to gather, publish, *and publicize* balance-of-payments data. *Survey of Current Business* 51, no. 7, part 2 (July 1971): 4–22, 33–35, 105–07, and the concluding comments of Bureau Director George Jaszi in his brilliant and witty review of the symposium, 212–13.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The headline on a recent back-page story in the *Journal* (9 August 1983) declared: "As Economy Continues to Revive From Slump, Country's Balance of Trade Grows Sicklier." An accompanying chart, drawn from Commerce Department data, shows net exports of goods and services declining steeply from over $50 billion on an annual basis in the fourth quarter of 1980 to about $10 billion at an annual rate in the first quarter of this year, and still headed downward.[7]

It is all quite puzzling. To begin with, why is this called "sicklier"? *If* surpluses are evidence of health and deficits are signs of sickness, shouldn't the correct description at least have been "less healthy"? But that is still not the basic question. Why should a deficit be regarded in the first place as evidence of economic ill health? We could probably all agree that some events which produce deficits are evidence of matters gone wrong. Short-term borrowing to finance grain imports made necessary by a harvest failure, for example, would push a nation's balance of trade toward deficit as conventionally defined. But the problem here is the harvest failure, not the deficit in the trade balance, and obsession with the deficit that results from the harvest failure obscures the problem.

Not only is the deficit a mere symptom of the problem, it is also a symptom of the problem's resolution. And that's extremely important to keep in mind. The deficit is evidence that funds were made available with which to purchase grain after the harvest failure, and thus to ward off starvation. Isn't the deficit, viewed in this larger perspective, something to welcome rather than to lament? Lamentation is appropriate with regard to the harvest failure; but the deficit is something for which the nation's citizens could properly be grateful.

We are still talking about deficits, however, without deciding what they are. An actual deficit cannot exist in an accounting system that *defines* credits and debits so that they are necessarily equal. Trade deficits must therefore be conceptual phenomena. A trade deficit must be a disequilibrium, not an actual inequality between purchases and sales. And a disequilibrium, we have argued, entails the isolation and exclusion of some factors for purposes of analysis. What do the keepers of the trade balance exclude in order to calculate a deficit or surplus? And why?

They do not offer us an unambiguous answer. Let me therefore suggest on my own that they intend to exclude what we may call "involuntary" transactions. They assume that international exchange includes two distinguishable kinds of transactions. Some are

[7]Alfred L. Malabre, Jr., "As Economy Continues to Revive From Slump, Country's Balance of Trade Grows Sicklier," *Wall Street Journal* (9 August 1983), p. 56.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

undertaken for the sake of prospective advantage; people initiate such transactions because they hope to gain something from them. These "autonomous" transactions will ordinarily tend to balance each other off; a nation's imports will be basically financed by means of its export earnings. Imports and exports, it must be remembered, include services as well as merchandise, and services include both the loan of capital and payments for the use of capital.

Almost inevitably, however, on this view of the matter, the "autonomous" transactions initiated by households, business firms, governments, and other agencies will fail to produce a precise match between debits and credits in each trading nation. The difference will have to be made up by compensating transactions, or what we are calling "involuntary" transactions to indicate that the parties initiating them do not undertake them for the sake of prospective advantage to themselves, but rather to accommodate the actions of others. Thus, if a nation's financial institutions increase their holdings of deposits denominated in a foreign currency, *not* for the sake of the interest return on those deposits, but rather to compensate for a merchandise net export surplus, that increase in deposits represents a surplus in the nation's balance of trade (and a deficit for the nation whose liabilities have increased). Deficits and surpluses are calculated, then, by excluding from the totals of export and import transactions all such "involuntary" or merely compensating transactions.

Some Caveats

This use of the equilibrium concept strikes me as thoroughly illegitimate. To begin with, a distinction between "autonomous" and "involuntary" transactions is hard to draw without abandoning the basic premise of economic theory, that actions represent rational choices under constraint. Moreover, commercial banks clearly do not hold foreign assets in order to square the national trade balance. Nor do central banks! Just what does make central bankers tick is a mystery to many, of whom I am one; but I am confident that no central bank anywhere adjusts the composition of its asset portfolio in order to equate the balance of payments, if for no other reason than that it cannot possibly acquire the information it would need to do so.

The managers of financial institutions, whether private or official, national or international, affect the balance of payments in the same way that ordinary exporters and importers do it: as the consequence of pursuing their own interests in a situation with diverse but limited options. This is not to say that central bankers do not pursue what they regard as the national interest. They well may. But when they

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

do so, they do *not* do it by aiming at a balance in the balance of international payments. We know this is not their target because we know this is a target they cannot see. They are necessarily aiming at something else if they are "aiming" at anything at all.

Their actual target might be some particular foreign exchange rate, or some rate of growth in a domestic monetary aggregate, or some desired interest rate, or improved relations with influential parties who want central bank intervention in foreign exchange markets, or even the election of a particular presidential candidate.[8] There are many possibilities. And that is the problem. The allegation of a trade deficit amounts to a vague claim that international exchange transactions are out of order and must be set right. The fundamental issues of exactly what is out of order and how it got that way do not have to be addressed. With the problem undefined, the solution is necessarily undefined. A wide variety of actions might be appropriate. Since even experts disagree extensively on just how any particular policy move is likely to affect the long list of important variables in the world of domestic finance and international exchange, the declaration of a trade deficit amounts in practice to a kind of declaration of martial law. What is most dangerous about such a declaration is that it gives government officials a license to subordinate the rule of law and respect for established rights to considerations of political advantage.

I do not want to be misunderstood. I am not now claiming, whatever I might believe, that we would be better off if central banks stayed out of the foreign exchange markets. Nor am I trying to construct an argument for unrestricted international trade. My claim is a much more limited one. It is that whatever the proper role of government might be in affecting the course of international trade, the concept of trade deficits and surpluses or disequilibrium in the balance of payments darkens counsel. It has no agreed-upon meaning. It ought to be abandoned, so that the way can be cleared for more responsible and effective discussion of the issues that concern us.

I have never encountered a case in which the concept of a balance-of-payments disequilibrium was used to interpret an economic problem where the problem could not have been more clearly explicated, in my judgment, by abandoning the concept. What would we substitute for it? Whatever assertion the balance-of-payments concept is

[8]In support of the last possibility, see Lindley H. Clark, "The Odd Couple: Treasury and Fed Try to Reelect Reagan," *Wall Street Journal* (16 August 1983), p. 33.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

concealing in each particular case. Every claim of a balance-of-payments disequilibrium can be more accurately and adequately expressed as a prediction, such as "The dollar will depreciate relative to certain other currencies," or "Certain desired imports will not be available unless foreign lenders can be persuaded to extend credit," or "It is going to be increasingly difficult for producer A to sell in market Y," or "Important political support will be secured by imposing quotas on the importation of goods M and N."[9]

Conclusion

I am uncomfortably aware of the violence that this recommendation does to long-established tradition. The concept of a balance of international payments has been called, by economists far more reputable than I, a significant analytical achievement.[10] I am claiming that it was in fact and from the beginning a conceptual device that concealed more than it revealed. And the trouble with such concepts in the social sciences is that they facilitate the presentation of political arguments in the garb of empirical assertions.

I think Adam Smith was right. "Nothing . . . can be more absurd than this whole doctrine of the balance of trade."[11] It is a concept originally devised and promulgated by merchants in order to promote their special interests under the pretense of protecting the national interest. And a government that tries to watch over the balance of trade has embarked upon a task that is intricate, embarrassing, and fruitless.[12]

[9]At a time when macroeconomic theory is in such unsettled shape, it seems to me more than ever imperative to strive for clarity in our assertions in this area. We all use theory as a shorthand in making empirical assertions, as when we say that "the outfielder missed the fly ball because of the sun." This practice begins to create confusion as soon as relationships "settled" by theory start behaving in ways inconsistent with the theory (or consistent with only *some versions* of the theory). Relevant examples include relationships at the present time between money stock growth rates and interest rates and between foreign exchange rates and relative rates of inflation.

[10]In his *History of Economic Analysis*, Joseph Schumpeter calls the balance of payments "an important datum in the diagnosis of the economic condition of a country and an important factor in its business processes." Against his explicit claim that development of the concept represented a significant analytical advance, I would adduce his own discussion on pages 352–53, including the long footnote 6. Schumpeter's actual discussion seems to me to demonstrate the inherent ambiguity of the concept and its vast potential for buttressing question-begging arguments. Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), pp. 352–53.

[11]Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (Oxford: Clarendon Press, 1976), book IV, chapter III, part II, paragraph 2. The quotation is on page 456 in the Modern Library edition.

[12]Ibid., book IV, chapter I, paragraph 10. See pages 376–77 in the Modern Library edition.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

U.S. TRADE POLICY AND NATIONAL SECURITY

Thomas D. Willett and Mehrdad Jalalighajar

Introduction

There is a long history of intellectual interest in and public concern with the interrelationship between trade policy and national security. In general, mainstream economists with their emphasis on efficient resource allocation and economic prosperity have favored liberal trade policies. Those adopting a broader perspective on international relations, however, have argued for various measures to restrict international trade to promote self-sufficiency, reduce strategic vulnerability, and enhance national power. Although the latter view typically reflects a nationalistic perspective, there is also a tradition that fears international trade will stimulate conflict and conquest. From this perspective, relatively small self-sufficient groups are seen as the basis for a harmonious peaceful world. The work of Plato reflects this view, and its continuing popularity among some utopian thinkers is reflected in E. F. Schumacher's *Small is Beautiful.*[1]

We believe that there are some genuine national security arguments for deviating from free trade. As Adam Smith well put it,

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

Thomas D. Willett is Horton Professor of Economics at Claremont Graduate School and Claremont McKenna College, Claremont, Calif. 91711. Mehrdad Jalalighajar is a Lecturer in Economics at Pomona College and a doctoral candidate at Claremont Graduate School. This paper draws heavily on "Economic Sanctions and National Security," a study the authors are preparing for the Claremont Center for Economic Policy Studies and the Keck Institute for International Strategic Studies.

The authors wish to thank Thomas Borcherding, James Dorn, Ross Eckert, Gary Evans, Sonia Gold, James Lehman, Rodney Smith, Edward Tower, and participants in the Claremont Economics Workshops for helpful comments on an earlier draft of this paper.

[1]For a discussion of Plato's view on this issue, see Will Durant, *The Story of Philosophy* (New York: Washington Square Press, 1952), pp. 19–20 and 37–38; and E. F. Schumacher, *Small is Beautiful* (New York: Harper and Row, 1973).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"defense is more important than opulence."[2] However, trade restrictions are seldom the most efficient way to deal with externalities associated with national security. (The prohibition of sales of advanced military technology and hardware to potential enemies is the major exception.) Many of the trade restrictions actually imposed in the name of national security have merely promoted protectionist interests or unwise foreign policy strategies rather than U.S. security objectives. For example, the U.S. oil import restrictions during the 1960s drained our domestic oil reserves and increased our vulnerability in the 1970s. The use of economic sanctions also has frequently been counterproductive. Therefore, the conflict between liberal trade objectives and sensible foreign policy is not nearly as great as is often suggested.

Liberal Trade vs. National Security Objectives

It is easy for economists to feel that free trade and national defense objectives necessarily conflict. Strategic export controls, grain embargoes, Olympic boycotts, oil import quotas, and arguments for protection of the steel and automobile industries are just a few examples. On balance, however, it seems likely that national security concerns have done more to promote than to retard trade liberalization policies. Indeed, even though the direct economic damage of retaliatory actions, which import restrictions are likely to induce, is an important argument for free trade, the linkage of such effects to broader national security objectives has perhaps been an even more powerful complementary consideration.

Counter to beliefs that self-sufficiency promotes peace and trade restrictions enhance national security is the powerful set of arguments that freer international trade promotes peace and makes good neighbors. Due in large part to the acceptance of free trade principles by Secretary of State Cordell Hull, liberal trade policies became an important ingredient in restoring the economic prosperity of the West and combating communism in the post-World II period.[3] As a major bipartisan plank of U.S. foreign policy, however, liberal trade policies

[2]Adam Smith, *The Wealth of Nations,* Modern Library ed. (New York: Random House, 1937), p. 431.

[3]For more detailed discussion, see David Calleo and Benjamin Rowland, *America and the World Political Economy* (Bloomington: Indiana University Press, 1973); and Lawrence Krause and Joseph Nye, "Reflections on Economics and Politics of International Economic Organizations," in *World Politics and International Economics,* ed. Fred Bergsten and Lawrence Krause (Washington, D.C.: Brookings Institution, 1975), pp. 323–42. We do not deny that Hull had a considerably overoptimistic view of the contributions that liberal trade policies could make to promoting peace.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

did not embrace all aspects of free trade. The adoption of strong restrictions on trade with enemy countries, including a complete prohibition of trade with communist Cuba, became part of the free-trade strategy, as did the acceptance and even encouragement of economic discrimination against the United States by our allies in the Common Market.[4]

Although the national security-based strategy has had some negative effects,[5] it must be judged an overall success. This strategy helped promote the successive rounds of postwar tariff reductions through the General Agreement on Tariffs and Trade (GATT), and helped counter pressures for selective tariff, quota, and regulatory protection of domestic interest groups.

The increased pressures for protectionism of the 1970s and 1980s are often cited as evidence of a new era of mercantilism, but this new mercantilism differs fundamentally from the old variety. Old-style mercantilism emphasized the pursuit of power and plenty through a strong national government. The recent increase in protectionism has been much more a result of relatively weak national governments succumbing to powerful domestic interest groups, the very antithesis of traditional mercantilism.[6]

[4]On our relationship with the Common Market, see Randall Hinshaw, *The European Community and American Trade: A Study in Atlantic Economics and Policy* (New York: Praeger Publishers, 1964); and Leland B. Yeager and David Tuerck, *Trade Policy and the Price System* (Scranton, Pa.: International Textbook Company, 1966), chaps. 15 and 16. On trading with the enemy, see Yeager and Tuerck, *Trade Policy*, pp. 129–30; and their *Foreign Trade and U.S. Policy* (New York: Praeger Publishers, 1976), pp. 155–57; Jonathan B. Aranson, "Technology Exports Can Hurt Us," *Foreign Policy*, 25 (Winter 1976–77): 180–94; Henry Kissinger, "Trading With the Russians," *The New Republic* (2 June 1982): 14–16; and G. Warren Nutter, "Economic Warfare," in his *Political Economy and Freedom: A Collection of Essays* (Indianapolis: Liberty Press, 1983), pp. 222–36.

[5]Common markets are clearly adverse to the narrow, short-term economic interests of the United States. But from a global perspective, it is not possible to say whether the formation of common markets, with their free internal trade and common external tariffs, are moves toward or away from free trade. Trade is both created and diverted, and the policy changes that would have occurred in the absence of the common-market arrangements are often unclear.

On the economic effects of the European Common Market, see Bela Balassa, *Trade Liberalization Among Industrial Countries: Objectives and Alternatives* (Hightstown, N.J.: McGraw-Hill, 1967).

[6]See Ryan C. Amacher, Robert Tollison, and Thomas D. Willett, "The Divergence Between Trade Theory and Practice," in *Tariffs, Quotas and Trade: The Politics of Protectionism*, ed. Walter Adams, et al. (San Francisco: Institute for Contemporary Studies, 1979), pp. 55–66; and Fred Bergsten, Robert Keohane, and Joseph Nye, "International Economics and International Politics," in Bergsten and Krause, *World Politics*, pp. 3–36; and Stephen D. Krasner, *Defending the National Interest* (Princeton: Princeton University Press, 1978), pp. 5–34. We should note that the old mercantilism was

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

There are several types of national security considerations for restricting trade.[7] The narrowest type involves attempts to provide for the maintenance and potential expansion of materials and productive capacity to meet direct military needs. The counterpart of this consideration is to make the attainment of this objective more difficult for potential enemies.[8]

Broader considerations of national security go beyond direct military needs to the general productive capacity of the economy. For example, concerns over disruptions of oil supplies have gone far beyond the question of whether the United States could undertake military operations in a national emergency. Similarly, concern about U.S. exports to communist nations extends well beyond attempting to block access to weapons technology and strategic materials. Some have opposed any trade that strengthens the Soviet economy, even if it benefits the United States or increases our short-run dependence on communist countries.

An even broader view of national security sees the regulation of international exchange as part of a grand political, economic, and military strategy to achieve national objectives. Those holding such a position differ widely over the appropriate limits of U.S. policy objectives. Some favor a noninterventionist defensive posture, but others advocate aggressiveness to promote the U.S. power position and induce foreigners to comply with our objectives. Economic sanctions and concessions then become bargaining chips in a global power game.[9]

---

not completely free of the special interest pressures that have generated the recent increase in protectionism. See Barry Baysinger, Robert Ekeland, and Robert Tollison, "Mercantilism as a Rent Seeking Society," in *Towards a Theory of the Rent Seeking Society*, ed. James Buchanan, Robert Tollison, and Gordon Tullock (College Station, Tex.: Texas A&M University Press, 1980), pp. 235–68.

[7]For useful overviews and extensive references to the literature on this subject, see Franklyn D. Holzman and Robert Leguold, "The Economics and Politics of East-West Relations," in Bergsten and Krause, *World Politics*, pp. 275–320; Charles Kindleberger, *Power and Money* (New York: Basic Books, 1970); Klaus Knorr, *The Power of Nations* (New York: Basic Books, 1975); Klaus Knorr and Frank Trager, eds., *Economic Issues and National Security* (Lawrence, Kan.: Allen Press, 1977); Benjamin Cohen, *American Foreign Economic Policy*, Part IV (New York: Harper and Row, 1968); and Yeager and Tuerck, *Trade Policy* and *Foreign Trade*.

[8]We favor a narrow definition of U.S. power and security interests. We find views that "the major concern of the state is prestige," and that "the means to prestige is power" to be distressingly accurate as a description of motivation, but exceedingly dangerous as a normative prescription (see Kindleberger, p. 57).

[9]An important intermediate case, which will not be dealt with in this paper, concerns the possible need for government regulation to counter foreign monopoly positions caused, for example, by state trading. On this problem see Jacob S. Dreyer, "Countervailing Foreign Use of Monopoly Power," and Comments by Franklyn Holzman,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Theory versus Practice

All of these national security considerations may offer legitimate reasons—based on externalities or public goods—for government policies that alter the allocation of resources.[10] The economists' case for free trade is a presumption, not an ironclad rule. But accepting a point in theory is one thing; seeing how it has been applied in practice is another.

Even a cursory glance at the history of postwar trade restrictions, imposed by the United States in the name of national security, makes us question whether in practice a policy of complete free trade (except for military secrets, narrowly defined) might not have served our security interests much better. Not only were U.S. trade policy approaches often inefficient or ineffective, they were often counterproductive. For example, the oil import quotas imposed by the United States during the 1950s and 1960s made the U.S. economy more vulnerable to the oil shocks of the 1970s.[11] If the United States had relied more heavily on cheap foreign oil during the 1960s, its short-term productive capacity in the 1970s would have been sufficient to neutralize the 1973–74 OPEC embargo. Consequently, the United States could have perhaps avoided most, if not all, of the subsequent solidification of OPEC and skyrocketing oil prices. Although the stated objective of U.S. oil import policy during the 1950s and 1960s was national security, the real intention of the program was to protect domestic oil prices. American consumers paid dearly for policies to prop up domestic oil prices, but these costs pale in comparison with the costs of strengthening the OPEC cartel.

There is an important national security rationale for government oil policies, but the appropriate strategy, both in minimizing economic costs and maximizing security benefits, is a combination of oil stockpiling and subsidies for finding and capping oil fields for emergency use. Such a strategy follows from the application of basic economic principles. When an activity like capping oil fields generates

---

Robert Tollison, Richard Caves, Charles Diaz-Alejandro, Roger Shields, and Edward Tower in *Challenges to a Liberal International Economic Order*, ed. Ryan Amacher, Gottfried Haberler, and Thomas D. Willett (Washington, D.C.: American Enterprise Institute, 1979), pp. 317–77.

[10]See Ryan C. Amacher, Robert Tollison, and Thomas D. Willett, "Tariffs vs. Quotas to Control Oil Imports: Comment," *American Economic Review* 63 (December 1973): 1031–34; and *The Oil Import Question*, A Report on the Relationship of Oil Imports to the National Security by the Cabinet Task Force on Oil Import Control (Washington, D.C.: Government Printing Office, 1970).

[11]See James Cox and Arthur Wright, "A Tariff Policy for Independence From Oil Embargoes," *National Tax Journal* 28 (March 1975): 29–42.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

marginal external benefits because it increases our security, then a subsidy will produce less economic distortion than trade restrictions. The qualification *marginal* is crucial because the levels of production or stockpiles needed for emergency or for national defense may often be below the levels generated by private market incentives alone. In such instances no government subsidy is needed.[12]

One could argue, for example, that national defense requires the United States to maintain the steel and automobile industries. However, it is not clear that national security considerations should prevent us from decreasing the size of these industries if market conditions warrant it. On the other hand, the private market will probably stockpile less than an optimal amount of oil. This will be especially true if there is a strong likelihood that price controls will be imposed on U.S. oil in the event of a major supply disruption like the OPEC embargo. In this case there is a strong argument for some government stockpiling.[13] Although the United States has finally adopted a stockpile strategy, its implementation has been far from efficient.[14]

The notion that subsidies are almost always more efficient than trade restrictions, when there are domestic distortions,[15] has an additional advantage: The subsidy makes the costs of the program explicit. For this reason those seeking government subsidies prefer to receive them in more disguised form. Thus, special interest groups will generally prefer a quota to a tariff, which in turn will be preferred to a subsidy—just the opposite from the way these measures would normally be ranked from a public interest perspective.[16]

[12]James Buchanan and William Craig Stubblebine, "Externality," *Economica* 8 (November 1962): 371–84.

[13]On this point see the recent exchange between Milton Friedman and David Teece and James Griffin in *Journal of Contemporary Studies* 4 (Summer 1982): 55–60.

[14]See James Plummer, "United States Oil Stockpiling Policy," *Journal of Contemporary Studies* 4 (Spring 1981): 5–21; and the contributions in George Horwich and Edward J. Mitchell, eds., *Policies for Coping with Oil-Supply Disruptions* (Washington, D.C.: American Enterprise Institute, 1982).

[15]See Harry Johnson, "Optimal Trade Intervention in the Presence of Domestic Distortion," in *Trade, Growth and the Balance of Payments: Essays in Honor of Gottfried Haberler*, ed. Robert Baldwin, et al. (Chicago: Rand McNally, 1965) pp. 3–34; Warner Max Corden, *The Theory of Protection* (Oxford: Clarendon, 1971); Yeager and Tuerck, *Trade Policy*, pp. 127–29.

[16]Under static competitive conditions, equivalent tariffs and quotas may be defined. Quotas, however, make it easier to pursue anticompetitive policies at home. And where there is monopoly power abroad, tariffs will tend to have more favorable terms of trade effects than quotas. On these points, see Richard J. Sweeney, Edward Tower, and Thomas D. Willett, "The Ranking of Alternative Tariff and Quota Policies in the Presence of Domestic Monopoly, *Journal of International Economics* 7 (November 1977): 349–62; and Thomas D. Willett, "Oil Import Quotas Are Not the Answer," *Journal of Energy and Development* 1 (Spring 1976): 240–48.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Economic Sanctions

Not all ineffective or counterproductive national security restrictions have resulted from the lobbying of special economic interests. Export restrictions are seldom politically popular at home, at least with producers, yet they have often been used to manipulate East-West trade relations. The recent grain embargo against the Soviets and the prohibition of U.S.-related firms providing goods and services for the European-Soviet gas pipeline were hardly the result of domestic political pressures. The broad definition of restricted strategic goods adopted by the United States also has resulted in lost sales and complaints from American firms throughout most of the postwar period.[17] Unfortunately, the absence of protectionist causes for national security trade restrictions is no guarantee that such restrictions will promote U.S. security objectives. All of the above-mentioned measures in large part failed to achieve their intended goals. Indeed, a good case can be made that they were actually counterproductive.[18]

The dismal record of economic sanctions and trade restrictions in promoting national security is due to the repeated failure of policy makers to recognize three major considerations—one economic and two political. The economic consideration is that, except in unusual situations, alternative sources of supply and the transshipment of goods will nullify most of the intended effects of economic restrictions.[19] A single country seldom has sufficient control over the market of an important good for a boycott or embargo to have any major impact. Moreover, in the absence of substantial market power, trade restrictions will primarily injure the country that imposed them. The restrictions limit mutually beneficial trade without producing serious hardship on the target country.

[17]See Joan Edelman Spero, *The Politics of International Economic Relations* (New York: St. Martin's Press, 1977), chap. 7.

[18]On the history of the general ineffectivenss of economic sanctions, see Margaret Doxey, *Economic Sanctions and International Enforcement* (New York: Oxford University Press, 1980); and Knorr, *Power of Nations*.

[19]On economic considerations, see Klaus Knorr, "The Limits of Economic and Military Power," *Daedalus* 104 (Fall 1975): 229–43; Johan Gaulting, "On the Effects of International Economic Sanctions: With Examples from the Case of Rhodesia," *World Politics* 19 (April 1967): 378–416; Margaret Doxey, "Economic Sanctions: Benefits and Costs," *The World Today* (December 1980): 484–89; Thomas Bayard, Joseph Pelzman, and Jorge Perez-Lopez, "Stakes and Risks in Economic Sanctions," *The World Economy* 6 (March 1983): 73–87; and Gary Clyde Hufbauer, *Economic Warfare: Sanctions in Support of National Foreign Policy Goals* (Washington, D.C.:Institute for International Economics, 1983), pp. 53–73.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The United States has tended to restrict a much broader range of exports to communist countries than most of our allies. The major effect of these restrictions, however, has not been to deny the Soviets access to the high-tech goods that the United States has embargoed. Instead, our trade restrictions have tended to deflect sales from U.S. to European firms.[20] Likewise, while the reduction in U.S. grain sales to the Soviet Union does appear to have had some adverse effects on the Soviet economy, much of the reduction was offset by additional sales from other countries.[21] Even if all suppliers honored pledges not to increase their sales to the target countries, any importer could increase his purchases and transship them to the target country.

Some policing of transshipments may be possible, but it will seldom be fully effective. This is why proposals for the United States to lead a food war against OPEC, to combat their use of oil weapon, were ill-founded. For the same reason, although OPEC had sufficient market power to severely damage the West, it could not effectively enforce its selective embargo of sales to the United States and the Netherlands. (The apparent differential effect on the United States was due to our price control measures, not to the effectivness of OPEC's selective embargo.)

Thus, except for strongly differentiated products, it makes little sense to apply different policies to friendly and suspect suppliers (as was done with the oil import quota system). With complete fungibility, all that matters (except for differential transportation costs) is the total restriction of supply, not the initial pattern of its distribution. Of course, there are short-term adjustment costs in most product markets, so that initial trade patterns are not entirely irrelevant. Most markets, however, are much closer to complete than to zero fungibility.

Economic considerations imply that trade restrictions, unless imposed on a broad group basis, are unlikely to seriously harm the target country. Political considerations, however, suggest that sanctions are often counterproductive.[22] Unless the economic effects of sanctions are crippling, their use cannot force the target nation to change its behavior. The increased economic cost to a target government of continuing its policies seldom outweighs the political cost of appearing to give in to foreign influences. Most instances in which

[20]See Spero, pp. 294–96; and Franklyn D. Holzman, *International Trade Under Communism: Politics and Economics* (New York: Basic Books, 1976).

[21]See Robert Paarlberg, "Lessons of the Grain Embargo," *Foreign Affairs* 59 (Fall 1980): 144–62.

[22]For details, see Johan Gaulting, "Effects of International Economic Sanctions," and James Barber, "Economic Sanctions as a Policy Instrument," *International Affairs* 55 (July 1979): 367–84.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the threat of economic sanctions has been influential in changing foreign behavior have been cases of quiet bargaining and diplomacy, not the publicly visible adoption of sanctions.[23]

A case can be made that the adoption of sanctions can be useful by raising the expected cost to target countries of future actions intended to harm importers. But there is little chance that such a strategy can reverse current policies in the target countries.[24] For the strategy to work, predictability of response must be assured. Neither President Carter's nor President Reagan's use of sanctions were characterized by this feature.

Sanctions may not only make it more difficult politically for target governments to modify their behavior, but may even induce more aggressive or repressive behavior. Governments are often influenced by a range of inner-circle views, and imposing sanctions is as likely to strengthen the hands of the hawks as it is the hands of the doves. Even with a single controlling decision maker, the imposition of sanctions may generate more annoyance than repentance, and increase the likelihood of further belligerent behavior. An extreme example is the case of U.S. economic sanctions against Japan in 1941. Some people have argued that instead of dampening Japan's expansionist policies in the Far East, the U.S. sanctions were a significant factor in Japan's decision to attack Pearl Harbor.[25]

In general, economic sanctions need to be adopted as a common policy by a group of countries, if they are to be effective. This will often not be easy. In any sizeable group of countries there is likely to be a range of views about desirable policy strategies, and even where there is general agreement on group objectives, there is the free-rider problem to overcome.[26] (For example, all OPEC countries

[23]See the studies in Roy Weintraub, ed., *Economic Coercion and U.S. Foreign Policy: Implications of Case Studies from the Johnson Administration* (Boulder, Colo.: Westview Press, 1982); and the discussion of how publicity killed an apparent U.S.-Soviet deal to loosen restrictions on Jewish emigration to Israel in Spero, pp. 313–22.

[24]For the limited role that sanctions might play in Western strategy, see James P. O'Leary, "Rethinking NATO's Economic Strategy," *Journal of Contemporary Studies* 5 (Winter 1983): 51–64.

[25]For details on economic sanctions on Japan, see Yuan-Li Wu, *Economic Warfare* (New York: Prentice-Hall, 1952), p. 267.

[26]See James Barber, "Economic Sanctions." Domestic opposition and constraints may also be important, and failure to take these into account can lead to signals of weakness rather than strength when sanctions are adopted. On the importance of domestic political structures and constraints on international economic policies, see Peter Katzenstein, ed., *Between Power and Plenty* (Madison: University of Wisconsin Press, 1978); and Steven Krasner, "Domestic Constraints on International Economic Leverage," in Knorr and Trager, *Economic Issues and National Security*, pp. 160–81.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

agree that aggregate oil supplies should be restricted, but each country wants the other to undertake most of the cutbacks required.

Unlike the unilateral decisions by President Carter to boycott the Moscow Olympics and President Reagan to prohibt the use of U.S. firms and products in the construction of the European-Soviet pipeline, decisions to impose controversial sanctions should be reached only after careful, quiet negotiations with our allies. President Reagan's decision highlighted our conflict with European allies over the right to impose trading-with-the-enemy restrictions on the foreign subsidiaries of U.S. firms, entities that most foreign countries argue fall under their laws, not U.S. laws. This is the type of national sovereignty issue on which our European allies are united in their opposition to U.S. policy. To anyone with even a cursory knowledge of the tension-filled history of this issue, it was obvious that President Reagan's decision would generate strong opposition from our European allies, even if they had doubts about the wisdom of the pipeline project. The most the U.S. restrictions could have hoped to achieve was a short delay and small increase in the cost of completing the project.

We clearly are not enthusiastic about the use of economic sanctions in promoting national security objectives. However, we do see a potentially beneficial role for the use of sanctions as a way of reducing public outcries that still more serious action be taken. Developments such as the Soviet actions in Afghanistan and Poland and the seizure of the American hostages in Iran tend to stimulate public outcries that the U.S. government do something, even if there is little that realistically can be done in the short run. Diplomatic notes and speeches in the United Nations may not be enough to pacify public outrage, while military intervention might be foolhardy.[27] Economic sanctions can provide the desired political appearance of doing something, but with less risk that this will lead to military involvement than other alternatives. Thus, the use of sanctions may at times be highly effective in meeting domestic policy objectives without greatly increasing the risk of war.

Implementing such a strategy, however, would require sanctioning a very different set of activities compared to the traditional strategy of trying to inflict substantial economic damage on the target country. Activities of high symbolic (but low economic) importance should be sought. For both policy approaches, however, care should be taken to select those actions that our allies are likely to support.

[27]For details, see Fredric Hoffman, "The Functions of Economic Sanctions: A Comparative Analysis," *Journal of Peace Research* 4 (1967): 140–60.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Conclusion

While there are legitimate national security considerations for restricting free trade, we believe that the most appropriate form of government policy will usually not involve trade restrictions. In our judgment, a large part of the trade restrictions implemented in the name of national security is the result of protectionist pressures and unwise foreign policy strategies.

A similar type of analysis can be applied to the defense budget. Although the ratio of effective actions is undoubtedly much higher, rent-seeking behavior by bureaucrats and defense firms is likely to generate unnecessary outlays. We are not experts on the defense budget, but the argument that a high-tech bias in defense weapons procurement has led to excessive costs and underprovision of conventional defense needs is consistent with the public-choice analysis that explains why the few are so often able to gain protectionist objectives against the interests of the many.[28]

Advocates of liberal trade policies and careful monitoring of defense spending should not automatically be labeled as hostile to the idea that we need a strong national security position. Indeed, in our view these are essential elements in securing such a position. Recognition that defense is more important than opulence should not be used as an excuse to increase the size of the pork barrel. And from the standpoint of achieving broad foreign policy objectives, such as promoting a favorable image abroad, the adoption of sensible economic policies may be as or more important than increases in our military might.[29]

[28]See Ryan Amacher, Robert Tollison, and Thomas D. Willett, "Budget Size in a Democracy: A Review of the Arguments," *Public Finance Quarterly* 3 (April 1975): 99–121; idem, "Risk Avoidance and Political Advertising: Neglected Issues in the Literature on Budget Size in a Democracy," in *The Economic Approach to Public Policy*, ed. Ryan Amacher, Robert Tollison, and Thomas D. Willett (Ithaca: Cornell University Press, 1976); and idem, "The Divergence Between Trade Theory and Practice," in Walter Adams, *Tariffs, Quotas and Trade*, pp. 55–66.

[29]See James Chace, *Solvency* (New York: Random House, 1981). For recent discussions and references to the literature on the economic basis of international power, see Charles P. Kindleberger, *Power and Money*; and Klaus Knorr, *Power of Nations*.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

THE ECONOMIC CLAIMS OF NATIONAL SECURITY

Earl C. Ravenal

Preliminary Observations

Free trade, in and by the United States, is imperiled. Hardly anyone, in public expression, really believes in free trade; or, more to the point, hardly anyone believes in really free trade. Yet there are pockets of advocacy of free trade, despite all challenges, and pockets of belief in a noninterventionist foreign and military policy, despite all provocations.

That the tenets of free trade and a noninterventionist foreign and military policy go together is (as our Marxist friends are wont to say) no accident. For the common enemy of free trade and nonintervention alike is "mercantilism." Mercantilism can be defined narrowly or broadly, or differentiated into contrasting modes (for example, the "old mercantilism" and "new mercantilism" of Willett and Jalalighajar),[1] to suit the purposes of an argument. But a fair definition would stress the manipulation of the movement of goods, labor, capital, and even ideas, in international trade, to contribute to the enhancement of the "superior" national entity. Those who oppose mercantilism argue that, with such manipulation or subordination, trade (and the other movements of factors) will not long be free; indeed, that trade is even now not free, but rather substantially and variously impaired.

A notable portion of the present impairment of free trade stems from considerations of preserving or enhancing "national security." And so, it is concluded, a constructive and rational trade policy—to the extent that a nation is able to have one—in some sense "depends

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of International Relations at the Georgetown University School of Foreign Service, Washington, D.C. 20057. He is a former official in the Office of the Secretary of Defense.

[1]In Thomas D. Willett and Mehrdad Jalalighajar, "U.S. Trade Policy and National Security," *Cato Journal* 3 (Winter 1983/84): 717–27.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

on" a rational defense policy. And both, in turn, depend on, or follow from, (a) a constructive view of the international system in all its functional aspects, and the role of a nation within it, as well as (b) a view of a well-ordered domestic system, specifically the relation of the political subsystem to the productive function (what has been called, in a somewhat question-begging way, "industrial policy"). So the question of "national security" is intimately involved in the question of trade restriction. And the relationship, and the setting of the relationship, are not simple.

Trade and National Security

With these preliminary observations, we turn to the paper by Willett and Jalalighajar. Their paper contains many wise assessments, an interesting analysis, and, in some ways, a proper direction of thought. The authors begin with the intelligent observation that much trade restriction taken "in the name of" national security is really disguised protection; and their pervasive thesis is that in reality there is not, and has not been, much conflict between the claims of national security and the pursuit of free trade—that is, that trade and security generally and normally run in the same direction.

I agree, though in a limited way and not in the same way as the authors. The conjunction of trade and security is really composed of two possible propositions, or conditions. The first is, roughly, in a kind of logical shorthand: if not an enemy (or if an ally or a security partner), then (probably) more trade. To support this proposition, the authors invoke the post-World War II free-world economic nexus.

The second proposition—complementary, not derived—is, again in logical shorthand: if trade, no enmity (or no enemies). This proposition falls afoul of empirical evidence. The authors refer to the somewhat frayed pre-World War I argument that trading partners rarely (never?) go to war with each other. I would have thought that 1914 and 1939 (when the rather thick trading partners Germany and France went to war) had put an end to that faith.

Trading with the Enemy

Now the derived converse of this second proposition is: if an enemy, then no trade. And the authors take pains to admit this proposition, as if a kind of exception—that is, that enmity can reasonably be expected to preclude free trade. This is a point which appears, in the current policy context, as little more than a truism, and it tends to put the issue of free trade and cold war hostility beyond discussion.

The authors slide too easily past this issue. For the true, hard test of free trade, and of whether it should be, or even can be, preserved

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

if it goes against the grain of national security, is precisely the case of "trading with the enemy." I seem to recall a popular law school adage, to the effect that "hard cases make bad law." (Or is it the opposite? I never seem to remember.) In any case, I *prefer* the *opposite* formulation: That easy cases make nondescript law; and that the hard, exacting cases force the discovery of the precise principle that disposes two close cases into opposite conclusions.

And so it is not particularly interesting that in the postwar period the free nations, all virtually allies (that is, not enemies), constructed a relatively free international economic system (with global tariff reductions and concerted monetary management) that vastly expanded trade and, in turn, reinforced the bonds of common security against a common adversary. The postwar Bretton Woods or GATT system may or may not have been inspired essentially by national security objectives. In any case, that is a rather different point from the harder, *policy* point before us: Whether, *if* national security were, in some concrete case, to conflict with free trade, we should prefer national security to free trade; or whether—as I happen to believe—there is some good (not precisely a "national" interest but more the sum of relevant individual interests) that is higher than security alone (though security may be a component of it) that is essential to our social contract; and—to indicate the theoretical direction in which I am heading—there is only a minimum level of security that must not be breached, but *can* be approached by "allowing" free trade, even with "enemies." Within this latter formulation, it may be the case that we "strengthen" the "enemy" to some degree, as an incidental—certainly not an intentional—by-product of free trade.

In other words, we are groping for *limits*, more precisely those limits that elemental, undeniable national security places on the exercise of otherwise unhampered free trade. To put it in the words of Willett and Jalalighajar (p. 721): "[N]ational security considerations may offer legitimate reasons—based on externalities or public goods—for government policies that alter the allocation of resources." The question is what presumptions we should entertain about how tightly limited should be those "considerations," and therefore how limited should be this governmental intrusion into the marketplace.

The Propriety of Trade Restrictions

The libertarian economist Murray Rothbard once told me that he would "allow," say, General Dynamics to sell, say, Trident submarines to the Russians. I am not so sure. It is not enough to laugh off security. Even Adam Smith admitted this; he said: ". . . defense is

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

more important than opulence"[2]—presumably referring to a few hard and real cases.

The question of the propriety of some limits on trade suggests the further question of how a society makes this determination. Here we are searching for a comprehensive "model"—at least a framework—of how such "decisions" are made by a political system. This will include the questions of *what kind* of decisions they are, and *where* in that system lies the "authority" to make such decisions for the system. (In another sense, this will comprise a *calculus* of national security.) Such a model will explain, and in some sense justify, the intrusion of the national security function into the commercial objectives, or the otherwise optimum welfare, of society.

National Security as a Constraint

First of all, how would we characterize "national security"? Willett and Jalalighajar (p. 720) present a pretty good taxonomic definition: "meet direct military needs . . . the general productive capacity of the economy . . . regulation of international exchange as part of a grand political, economic, and military strategy to achieve national objectives . . . [and within this strategy pursue either] a noninterventionist defensive posture . . . [or] aggressiveness to promote the U.S. power position and induce foreigners to comply with our objectives."

My question, however, goes rather to the *type* of consideration that national security might be: That is, whether an objective or a constraint, and if the latter, whether a quantity to be traded off (say, against some kind of welfare) or a sort of limit. In my view—to state my position at the outset of this part of the discussion—national security is, or should be, primarily a constraint, or a set of constraints, upon a larger conception of the complex objective function or goal function of a system (a goal function that will also include economic achievement and economic freedom, and the "quantity of life" and the "quality of life," and may also include some elements of security). This objective or goal function, by the way, is not imposed on society from above by government or by some kind of Rockefeller-type "national goals commission," but is imbedded in the system and grows out of the system—the system consisting of the actions and preferences and aims of all of its individual autonomous components and constituents.

Looking at the claims of national security primarily as a constraint—and a minimal one at that—has its advantages, both concep-

[2]Quoted by Willett and Jalalighajar, p. 718.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

tual and practical. Indeed, many of the present excesses of our national strategy and our exercise of military power can be attributed to a false conception of the functional nature of national security considerations—precisely to regarding these primarily as *goals* in themselves, goals for our country in the world, or even worse, goals that our country has for other countries in the world and for the outcomes of their actions and interactions. I regard such external goal-positing as not just illegitimate but epistemologically absurd. At least, it is not what our "leaders" are paid to do.

So far it emerges that, in contrast to Willett and Jalalighajar, I regard decision making on national security and trade as part of a *rational* process, though it is subtle and complex and elusive and implicit. The authors, however, coming from a "public choice" orientation in decision theory, gravitate to models and descriptions of policy making that are, at best, *sub*rational—that is, not expressive of and resulting from the "sense" of an entire society but of diversely motivated interest groups, each attempting to suboptimize a situation for itself. Illustrative is these authors' invocation of the causes of the magnitude of defense spending (p. 727), attributing it, and its irregularities and inefficiencies ("high-tech bias," "excessive costs," "unnecessary outlays") to "rent-seeking behavior by bureaucrats and defense firms"—an ascription rather close to that of the "bureaucratic politics" theorists or to that of the exponents of the "military-industrial complex."

By contrast, my theoretical framework would place the burden of cause and blame on the overexpansive conception of the requisites of national security, specifically the incorporation of extensive external or "milieu" goals into our own society's set of objectives—indeed, the positing of such external states of affairs, whether of the situation and conduct of other nations in themselves or the structure of the international order in general, as objectives rather than merely as constraints (which are minimal conditions to be satisfied). Thus can a divergence of methodology lead to contrasting analyses and in turn contrasting policy prescriptions. The explanatory propositions of Willett and Jalalighajar may be partially true, but are, ironically, irrelevant to problems of "public choice," not in matters as relatively trivial as the procurement of this or that weapons system, but in matters as momentous as our national strategies, our force structures, and our total defense spending.

To get a better remedy, *what* needs to be changed? The two authors' explanatory bent would indicate a remedy that is equally arbitrary, and for that reason, etched in sand—a remedy close to that of the Nixon-Laird defense regime, or, before that, the Eisenhower-Wilson defense regime: that is, "fiscal guidance" from the top down.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Fiscal guidance may achieve momentary reductions, but they are not likely to be permanent or even long-lasting, because the real model that generates defense spending as its bottom line still exists, and underlies apparent behavior, and asserts itself in times of more stringent national security "necessity."

Instead of such rationally blind suboptimizing models, in short, we need a complex rational model that fixes the nature and place and magnitude of national security considerations. Such a model—and calculus—is described in the following section.

A Model of the National Security Function

In the calculus of national security, the whole package of security "requirements" is itself a set of constraints on the operation of the larger national system. That total economic-social-political system is (or should be) a welfare-maximizing system. It is false to treat security as an independent goal of the system, as if there were any sense in maximizing it (as opposed to improving the parameters through efficiency).[3]

Nevertheless, security is still a *condition* of the system. More properly, the security function constitutes a subsystem—a package of conditions that operates as a constraint on the overall welfare function, in several ways: Resources must be devoted to attaining the indicated level of security; and the longer-term preservation of a nation's security could be impaired by allowing its own welfare to attain such a high level that it diverts and strains world resources and conspicuously increases world disparities in living standards. If one assumes that security will be "bought" efficiently (an assumption that is realized more often in the abstract than in actuality, but nevertheless inspires continuing efforts toward its realization), then one can define security in terms of three relationships, or conditions that must be observed or fulfilled:

1. There is a minimum level, below which it is considered risky or imprudent to go. This level is the result of a calculation of

[3]Some sophisticated analysts have fallen into this trap. For example, Arnold Wolfers has said: "Security is a value, then, of which a nation can have more or less and which it can aspire to have in greater or lesser measure. . . . In both respects [absence of threats, absence of fear] a nation's security can run a wide gamut from almost complete insecurity or sense of insecurity at one end, to almost complete security or absence of fear at the other." In *Discord and Collaboration* (Baltimore: The Johns Hopkins University Press, 1962), p. 150. Actually Wolfers—following Harold D. Lasswell and Abraham Kaplan, *Power and Society* (New Haven: Yale University Press, 1950)—is making two mistakes, the first supporting the second: (1) Defining security as subjective leads to (2) considering it (a) a goal, and (b) expansible.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the "requirements" of preserving the essential elements of national integrity. The definition of this is political; the assessments and analysis are technical.

2. There is a maximum level, above which it is considered unnecessary to go. This level represents "sufficiency." It is established by (a) the resources available after providing for other welfare requirements; this is a political decision and is subject to adjustment after feedback; and (b) security "sufficiency" itself; this is primarily a technical assessment, though it is based ultimately on a political assessment of enemies, threats, and interests.[4]
3. There is a utility trade-off between security and the other components of welfare, such as private consumption and public services. This trade-off is established by a diffuse political process; at any point, the elasticity of the trade-off ratio varies, depending on how much of each good is already present.[5]

The labels on the first two of these relationships could be reversed, with no great loss of meaning. In fact, in one definition in fairly recent American history (the Nixon-Laird definition), "requirements" are *higher* than "sufficiency." The theoretical confusion can arise because, practically, "requirements" and "sufficiency" tend to approach each other and even coincide. Insofar as there might seem to be any gap between them, allowing the exercise of the trade-off between security and other components of welfare, this must imply the existence of a penumbra of near-vital or non-vital security interests. These might include such ultimately dispensable items as the health of our institutions (as opposed to their integrity) and the accessibility of the world to our influence.[6]

[4]The maximum level of security is also influenced by an estimate of the impact of our security preparations on the behavior of factors external to our own system, such as adversaries. Our exceeding a certain level might provoke an escalation on their part that would in turn affect our minimum security level.

[5]For an empirical analysis of this trade-off, see Bruce M. Russett, *What Price Vigilance?* (New Haven: Yale University Press, 1970), pp. 127–77.

[6]They might also include, by implication, certain milieu goals—or ambitions for the shape and character of the international system—including a "favorable" balance of power. The inclusion of milieu goals, such as the configuration of the international system, leads to de-finitizing the requirements of security: Derivative requirements become goals, from which new requirements are derived. This is simply another sense in which the security requirements of the "power-realist" theorists can, paradoxically, become indefinite, despite their efforts to define them. Of course, all security requirements are partially generated by external conditions that are not created by ourselves. But balance-of-power and other realist theories tend to expand the set of conditions that "require" responses.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

So these requirements or levels of sufficiency are themselves, as a set, a *constraint* on the operation of the larger welfare system—that is, the society seeking to improve the conditions of life for its citizens. The components of this constraint are various and could be expressed as a large, but finite, number of equations (or inequalities). There would be the *kinds* of requirement-constraints, such as treaty obligations, general alliance responsibilities, traditional affinities, strategic points, and credibility maintenance. And these would fall into certain larger categories: *systemic* constraints (the character and distribution of weights in the external environment—the "balance of power"); *cognitive* constraints (deep epistemological orientations that cause elites to construe movements in the external environment as "threats," or events that make a difference and must be countered); or *value* constraints (self-imposed or inherited attitudes, say, toward freedom or the autonomous exercise of sovereignty, that must be preserved against foreign pressures). Obviously, the more we "must" spend on defense, the less we have for other requirements, unless we tax ourselves or distort our economy—and either of these courses will amount to a charge on another area, though in a delayed or disguised way. A less obvious formal version of that statement is: The more restricted the *definition* of national security, the looser it is as a *constraint* on the operation of the whole system. If security is defined only as national survival against overt threats, the decision to use force, to mobilize the nation or its economy, will not often be invoked, and the amount of defense preparation will be consistently less burdensome.

There are also parameters in the total system that inhibit the attainment of security requirements. That is, other factors operate as a *constraint upon the constraint* of security: such diverse things as specific resource limits, the maximum level of the economy, boundaries of technology, unfavorable geography, economic vulnerabilities, the morale of citizens, the cohesion of society, even the "legitimacy" of government (that is, operationally, its capacity to demand and exact beyond what it delivers, conspicuously and immediately, in connection with these demands; its functioning above and beyond a set of ordinary transactions between individuals and their administrative structures). In this sense, it is quite possible for some nations to be in a "deficit" security position; indeed, at least 130 of about 160 "sovereign" states in the world probably fall into this category, and therefore either must seek security through alliance, as the deficit partner (in return lending the protector state, perhaps, only their frontiers as trip-wires and their territories as buffers), or must adopt, explicitly or implicitly, various forms of strategic surrender, early or

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

from the outset. Other, intermediate, nations are provisionally capable of defending their security—that is, they can threaten more harm to an aggressor than his conquest might be "worth" (though that evaluation is subject to circumstances outside the control of the defending nation).

This is a fair, though formalized, representation of how security relationships and values are determined. The model is both descriptive and prescriptive, as befits the process of policymaking, which is "strategic" in the sense that it is complex, structured, and above all deliberate. The model is already institutionalized to some extent in the politics and analysis that comprise the budgetary process. In reality the whole system of relationships and values is not "solved" simultaneously and statically, as in a mathematical linear programming problem. Analytic efforts within government are fragmented and compartmentalized. Relationships take shape tentatively and partially and in no necessary sequence. These facts introduce a dynamic—almost a dialectic—into the process. But it is nevertheless a calculus, and the structure of the model and the values of the constraints cannot be exceeded—except for the "soft" or self-imposed constraints, and then only by a deliberate "parametric" revision, which might carry, in turn, its own costs.

Society and the Individual

The need for a comprehensive model of how a society "makes" its decisions and of how and where "national security" cuts in, is exemplified in the treatment, by Willett and Jalalighajar, of certain means for enforcing trade restrictions, taken, presumably, for reasons of "national security" (pp. 721–22). Here they opine, prescriptively, that such means as government stockpiling of commodities, subsidies to encourage certain producer and consumer behavior, and creating and shutting in reserve supplies of, say, oil are preferable to—that is, "more efficient" than—trade restrictions. But how fundamentally valid are even these compromises of economic freedom and the working of the market, even if they are less evil than direct governmental restraint of trade? For one thing, the authors do not display enough faith in the price mechanism to "allocate" and bring forth supply, and to moderate and shape demand. (Though later, p. 724, they admit that, in the oil crisis of 1973–74, the less advantageous situation of the United States compared with certain other countries "was due to our price control measures, not to the effectiveness of OPEC's selective embargo.")

Just so. Then why should the government do anything? Indeed, even though the authors' paper goes in the right direction in

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

discouraging excessive and pointed government intrusion in the marketplace in the name of "national security," its basic trouble lies in its frequent assertions that there exists some "social optimum" that is more compelling, and more demanding, than the "private optimum." But how do we identify, let alone define or predict, such a "social optimum" apart from what is immanent in the range of private optima? Such a question indicates at least that, in determining the economic claims of national security, the most important variable is what brand of economist you are—that is, what you think "the economy" is.

Not that this precludes the authors from making a great deal of sense, on the pragmatic level, about the counterproductivity of export controls: That they merely deflect orders to competitors, or allow the target country to evade their effect through transshipment, or that the target nation can cope with sanctions, or if not, then just dig in its heels, which might even be worse from a political and especially a military standpoint. But, if their paper strays from a more consistent advocacy of really free trade, if at times it is even minimally permissive, in the name of national security, of destructive trade practices, in its tolerance for mercantilism—that is, instruments of state policy designed to interpose "national security" considerations that bring about results other than what a market would do—that, in my estimation, is because it stems from a cloudy model of how and where deliberate national security factors ought to intersect the more natural economic behavior of individual citizens and private organizations, and, beyond that, from a false orientation to the *function* of foreign policy in and for a society.

Indeed, what is essential to "mercantilism"—and almost sufficient for it—is the assumption of the collective first-person pronoun "we." In many cases there is almost a casual usage of this form, when discussing, for instance, "what the U.S. economy requires" (in *The New Republic*, 15/22 August 1983, p. 10): "How big a steel industry do we need? . . . We could easily get out of the textile business tomorrow. . . . Should we?"

It gets down to a question of the identity of the political body and the mandate of government—indeed, to the function of foreign policy. Perhaps the aggregation that we casually call "national" does not have a solid ontological basis, and to that extent efforts to "optimize" or "maximize" "national" advantage cannot even have prescriptive validity.

Mercantilism

A further word on mercantilism is in order, especially since this concept is a central point in the essay of Willett and Jalalighajar. That

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

is, almost in reverse, they attribute such ostensibly nationalist measures as protectionism more to "relatively weak national governments succumbing to powerful domestic interest groups, the very antithesis of traditional mercantilism" (p. 719).

Perhaps so, but we should have a more ample definition of mercantilism—one that includes *defensive* or *counter*offensive applications, and one that assimilates government's "succumbing" to the initiatives and requests of private interest groups to government action per se—in short, a definition of mercantilism that concentrates on its essential aspect: That it is a deliberate, strategic intrusion of noneconomic factors, at the state level, into the flow of more natural economic activity—in short, a distortion of the market. This definition of mercantilism would include the "old" aggressive mercantilism as well as the "new" defensive or retaliatory brand. It would encompass instances of trade-infringing behavior—not always "protection"—that are (1) punitive; or (2) defensive, that is, reducing vulnerabilities; or (3) preemptive, that is, refraining from "arming" an "enemy." Such a more ample definition would be more relevant to the present drift to mercantilist practices by most nations, including the United States.

Virtually all major interests in this country have come to subscribe to the orientation toward international affairs that I am calling mercantilist. (Mercantilism, again, is the assumption that the leaders of state have a mandate to mobilize the resources of private individuals and organizations to perpetrate objectives that might enhance the power and status of the state.) A salient contemporary case is the insistent brief of Felix Rohatyn,[7] which has attracted astounding support across the political spectrum. Rallying to the themes of "reindustrialization" and "planning" and "industrial policy," this argument proposes industry-government regulatory partnership; massive governmental subsidies; greater price and wage discipline, verging on comprehensive mandatory controls; incentives and disincentives to industrial location; the imposition and manipulation of tax burdens on energy; pervasive controls on capital movement and credit allocation; and protectionist curbs on embarrassing imports. These moves would achieve, in practical effect, far-reaching alterations of our political system.

In this program, we have the resurgence of the Hamiltonian scheme of a powerful and centralized government and a supreme and active

[7]Some examples, all in *The New York Review of Books*, are "The Coming Emergency and What Can Be Done About It," 4 December 1980; "The Older America: Can It Survive?" 22 January 1981; "Reconstructing America," 5 March 1981; and "A Matter of Psychology," 16 April 1981.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

executive, to promote the strength of the American state in the world—to serve the autonomous goal of foreign policy effectiveness.

Rohatyn himself has advised, quite consistently, radical constitutional surgery. Specifically, he would abolish the constitutional checks and balances, the internal restraints on executive power. And he would greatly augment military spending, and pair this with an unusually punitive version of conscription. Another proposal for explicit constitutional amendment, to establish a unitary, parliamentary system, was made by Lloyd Cutler, former counsel to President Carter ("To Form a Government," *Foreign Affairs*, Fall 1980). Cutler's pretext is also the incapacity of our system to project a coherent, effective foreign policy, as well as its inability to enforce allocative choices on domestic society. In a perverse sense, those would-be reformers of American state and society are right. For the American constitutional system does insist on the trade-off of political and economic liberty against foreign policy "effectiveness"—and makes that choice in favor of liberty.

Foreign policy is often conducted, not only as an autonomous activity, but as one that is primary and even dominant, to the point where the other functions of a state are required to support its external goals. But pretensions of autonomy or dominance constitute a pathology of the foreign policy function, not its unique justification. It is quite as valid to assert the reverse—that the foreign policy function ought to support other values that the state is organized to realize for its citizens. Putting the matter in that way, one can challenge the very "foreign-ness" of foreign policy. Its proper test is how well it serves the domestic interests of citizens. One might almost call foreign policy an extension, or a limiting case, of domestic policy.

Only after insulating against harm and conserving resources should a foreign policy be judged by how well it provides (not demands or enforces) opportunities for its citizens to interact constructively with the "outside" world (in commercial, social, cultural, and humanitarian activities). Beyond that, the organization of the international system per se—whether to subordinate it to American "primacy" or to accomplish "world order" on its own terms—is a questionable function, at best a marginal task.

Foreign policy, then, must be seen not as a lance, but as a shield. It is not a vehicle for propagating our values or a pretext for projecting our fantasies. Our primary business is to operate our unique political system, enjoy and enhance our economic activities, and repair and perfect our society. The ultimate justification for the foreign policy function itself is that it puts a shell around the internal process of the nation. In a very real sense, foreign policy begins and ends at home.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

A Prescriptive Finale

Whether a government can even have a mandate beyond the defense of individual citizens and their core interests—their lives, their domestic property, and the integrity of their political choices—is the relevant question. If we insist on that limited role of government, we can go a long way to "de-mercantilize" our foreign policy—both in its security and its trade aspects.

If we are not to damage our domestic system, our individual producers and consumers, we must do three things. First, we must learn to differentiate the strategic or political-military functions, those few matters of truly vital interest, and the other functional areas of national action, those real but lesser and ultimately alienable interests that our citizens might have in the world. Second, we must reject the "linkage" between these sets of functions that has been called, by Kissinger and others, "a fact of life," but is so mischievous and deleterious when deliberately applied to international bargaining. Third, in order not to extend the palette of true national security concerns so that it smears across all the other values and interests, we must draw back to a security perimeter that has two interacting and mutually reinforcing characteristics: credibility and feasibility; that is, a line that we must hold, as part of the definition of our sovereignty, and a line that we can hold, with advantage and within constraints, over the long haul.

The *consistent* observance of such a broad policy will not only contribute to international understanding of our behavior and of the essence of our system, but will also gain respect for them.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

THE POLITICAL ECONOMY OF TRADE POLICY

J. Michael Finger

It takes a perceptive mind to find logic in U.S. trade policy. Our steel import policy destroys 50 jobs in the rest of the economy for each one saved in the steel industry. Restrictions on auto imports have added no jobs in the auto industry but transfer $2 billion each year from American to Japanese products. And we are considering supplementing it with a program that will provide a handful of jobs at the bargain price of just $750,000 per annum per job. The economy of the country might be at risk, but the prosperity of the policy community is assured. Indeed, the solutions this community provides for each year's trade-related industrial problems create even more problems the following year, and the public's response has been to encourage that process.

Other countries have done no better. European agricultural policy costs European consumers some $20 billion per year. For every $20,000 per year job protected in Swedish shipyards, Swedish taxpayers pay an estimated $50,000 annual subsidy. When Japanese consumers pay eight times the world price for beef, Japanese farmers are not made eight times better off. It costs them that much more to produce it. And, though Swiss wine drinkers pay $50 million more than they would at world prices, Swiss producers have nothing left over for high living. Internationally, though hard evidence demonstrates that developing countries do not need tariff preferences and that industrial countries derive net benefits from them, the industrial countries resist their extension and the developing countries waste political capital on their defense.[1]

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Chief of the International Economic Research Division, Development Research Department at the World Bank, Washington, D.C. 20433.

[1]World Bank, *World Development Report 1981* (Washington, D.C., August 1981), p. 33; Tracy Murray, "Preferential Tariffs for LDCs," *Southern Economic Journal* 40 (July 1973): 35–46; J. M. Finger, "GATT Tariff Concessions and the Exports of Developing Countries—United States Concessions at the Dillon Round," *Economic Journal* (September 1974); and Finger, J. M., "Effects of Kennedy Round Tariff Concessions on the Exports of Developing Countries," *Economic Journal* (March 1976).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The uniformity of effects of recent policy demonstrates that the only meaningful difference is between policy and no policy. And the nature of these effects suggests that the best thing policy advisers can do for the economy is to leave it alone. The intent of my discussion is to move us a little bit in that direction.

The Policy Players

I will first discuss the role of those who work on the economic theory of trade policy. Their distinguishing characteristic might be summed up as a very determined irrelevance to anything that actually takes place. Sometimes, however, they stray inadvertently into the "real world." I recently attended a seminar by a very prominent economist, eminently respected as a member of the liberal (in the free-people, free-markets sense) wing. His topic was the "Dutch disease," the generic term for countries that discover a rich new resource like oil or natural gas. He presented a masterful taxonomy of 16 cases in which one sort or another of government intervention was needed—the taxonomy being based on which sort.

Discovery of a buried treasure is something we would normally consider a stroke of good fortune. Only in the light of the most dismal of sciences would such a serendipitous occasion be described as a "disease." And only within the logic of a system that gives you the trade policies already mentioned would someone acknowledged as liberal discover the need for 16 different types of political intervention.

Next, there are economists who specialize in trade policy. Their theory and their empirical work is, in brief, a retrofitting of "political" variables onto conventional "pure trade" models. The primary characteristics of these studies are their conviction that the truth is in such models and calculations, and their insistent ignorance of any information about how things actually work—other than their own t-statistics. In general, economists have found that the U.S. government tends to protect industries with a comparative cost disadvantage, either natural (e.g., apparel) or man-made (e.g., steel).[2] To the economist, this is a comforting conclusion. If one knows the potential gains from protection, then one knows the structure of protection. Politics, history—everything but contemporary economic theory—cancels out in the solution, and modeling the determination of this structure requires no knowledge of how decisions about protection are made.

[2]See J. M. Finger, "Ideas Count, Words Inform," paper presented at Conference on International Trade Problems and Policies, Monash, Australia, February 13–15, 1984.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The most damaging criticism I know for this approach is that the industry of people who make a living representing or resisting petitioners for import relief are mostly unaware of the material it has generated. Let me emphasize that I am not siding with the lobbyists-lawyers. Nothing tests the digestion more than the $15 "policy forum" lunch, to the tune of a lawyer, newly infatuated with numbers, explaining his views of protection. However, one important rule in Washington is, "Never tell two jokes about someone who makes more money than you do." Hence, I will confine my lighter criticisms to economists, most of whom do not live well, even by the standards of bureaucrats. When I discuss lawyers I will be appropriately somber.

The Policy Making Process

The most intriguing characteristic of trade policy is how dull it is—an unbroken murmur of administrative regulations, gray suits, pages of numbers without text, and endless international negotiations over one millimeter more or less on the circumference of tomatoes. If indeed "trade theory is about whose hand is in whose pocket, and trade policy about who should take it out," how do we manage to make the policy process so dull?

A first answer is that we have allowed the process to become professional. Trade policy is not a sideline for people who buy and sell goods across international borders, or compete with those who do. It is the profession of a Washington community that represents these interests in the day-to-day struggle to identify and exploit the opportunities provided by the set of policies on the books, or to nudge that policy set in a direction favorable to the interest they represent.

How, in this colorless community, do we distinguish the free traders from the protectionists? Easy. The free traders always say "Externality!" before they take your money. You will find on their business cards, in a special ink visible only through venal eyes, the inscription, "Externalities fitted to any proposed plunder of the public purse."

The worst part of making the trade policy business professional is that the dominant instinct of everyone who knows anything about it is to keep the process going. Anthropologists have observed the same instinct in four-footed animals. When wolves or foxes fight for possession of territory, a mate, or some choice morsel of food, they do not kill each other. At some traditional signal—the flick of an ear, the lowering of the tail—the dominant protagonist relaxes just sufficiently to allow the other to escape. Thus, rights to the prize are determined and the species is preserved. Anthropologists call this

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

displacement. In Washington, we call it, "Leaving a little something in the pot."

Unlike lower forms of animals, the Washington policy community has no natural predators. Worse, this den of foxes has convinced the farmer that only they are competent to mind the henhouse. When they squabble over a hen, their instincts lead them to do no permanent damage to each other—these rules do not apply to the hen. Given the record of trade policy since this species evolved, it is hard to find joy in discovering that it will survive.

Evolution of Trade Policy Professionals

In the true manner of science the answer to one question is a question itself. If the disaster of trade policy in the last decade is related to the evolution of this species of trade policy professional, what aberration of nature started its evolution?

The beginning of the answer is to realize that the success of farsighted North American and European leaders in restoring the convertibility of currencies and reestablishing an open international trading system after World War II was a victory of *tactics* not of *principle*. They built on the public's mercantilist beliefs that exports are the gains to the domestic economy and imports the costs. To this they added the strategy of reciprocity, of exchanging mercantilist "concessions," and arranged the negotiations about tariff reductions so that in each country the import-competing sector's pressure for protection was stalemated—but not overcome—by the exporting sector's interest in opening foreign markets.

Stalemating a major force in opposition to trade liberalization does not by itself generate a momentum toward it. There were, however, two other elements present, elements that put the system of tariff reductions into motion. One was a leadership elite convinced of the political and strategic necessity to construct an open economic system among the Western democracies. The other was the presence of strong public concerns on which the leadership elite could base its request for the authority to negotiate the reduction of trade barriers. In the United States, the public concern was the spread of Soviet communism; in Europe it was the feeling that the interwar depression and World War II came out of the beggar-thy-neighbor trade policies of the 1930s.

The sound basis of authority that the liberal-minded elites had allowed them to use such illiberal "details" as antidumping and safeguard mechanisms to advance their objectives. They could buy off resistance by writing in rules that specified when countries might

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"escape" their general commitment to maintain open markets; that is, when they could impose import restrictions. These rules, like those that defined the trade liberalization process, were soundly mercantilist. Protection was justified when import competition injured domestic producers, so that only those interests favoring protection were taken into account. The efficiency and user gains from freer international trade were ignored in the process.

The rules-defined mechanism for imposing trade barriers was effectively limited by the fact that national governments were led by people who still believed in the liberal system. In governing, this elite could be sure that there would be limited use of escape clauses, and that their strategy, on net, would promote freer world trade.

The GATT system established two distinct mechanisms for promoting trade liberalization: (1) the trade negotiations process through which trade barriers can be removed, but not imposed; and (2) the "administrative protection" process through which import restrictions can be imposed, but not removed. This second and less well known mechanism was a monster from its inception, but initially a small one chained to the service of an internationalist master. Over time, however, this domestic beast, nurtured by the same mercantilist forces that propelled the international mechanism it once served, would come to dominate. In both Democratic and Republican administrations, the species of policy professionals who could invent and manage the administrative mechanisms of U.S. trade policy would evolve symbiotically with the dependence of the United States on these mechanisms for controlling protectionist pressures. Accordingly, what was once a sop to the mercantilist-minded masses has become a national standard used to measure the public's interest in keeping domestic markets open to import competition.

Many elements have contributed to this reversal, to the protectionist footnote becoming the national text. Expansion of the general feeling that the government is responsible for each citizen's economic security is one. Perhaps more important is the changed mentality of the leadership elite. More of today's leadership generation develop their concept of the national economic interest by reading the law and participating in the Washington policy making process than by reading Adam Smith or the trade chapter in any economics text. To this mentality, protection is a victimless crime, and opposition to it is considered old-fashioned.

Finally, there is the willing complicity of political leaders in the emergence of these mercantilist administrative mechanisms as *the* way to gauge the national economic interest in keeping our markets open. There is also their complicity in the country's accompanying

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

dependence on a technocratic professional class to operate those mechanisms; that is, to tell the country where its interests lie. Spinoza pointed out in 1677 that nature abhors a vacuum, Harold Hotelling in 1931 that economics abhors a discontinuity. We are discovering today that politics abhors a fair fight, and therein lies the source of that complicity. It does not take very long in government to realize that nothing retards the pace of policy formation so much as a good clear statement of the costs (as well as the benefits) of each proposed course of action. Lester Thurow, in the modern fashion of a bookfull of numbers and technocratic phrases such as "zero-sum game," makes the same point.[3]

Mechanisms that focus only on the costs of import competition are thus tailor-made to get things done. And the technical complexity of the mechanisms, involving literally thousands of lines of rules and administrative regulations, has obvious appeal to the tactical, technocratic mentality that we now confuse with education and impose on most of our best minds. (I myself, not qualifying for this group, never had a very good education, hence have been able to overcome it and revert to a more natural state.) The complexity of the process serves also to obfuscate—the busier we are working out the answer to the wrong question, the less likely we are to realize what the right one is. This is particularly important for those who bear the costs of the policies we come up with.

Taming the Mercantilist Beast

Let us turn now to remedy. What might be done to chain the mercantilist beast and to destroy its symbiotic species of policy professionals?

Rules, Retaliation, and Reciprocity

More detailed rules? They sustain the policy professionals, while the national economic interest lies in destroying them—in giving policy control back to the amateurs. Remember, the rules represent only the import-competing sector. The law is on their side.

Retaliation—the threat that the partner country will respond tit-for-tat by closing his markets? It is to modern policy as DDT is to modern boll weevils. There have evolved forms of policy that are impervious to it; for instance, the orderly marketing agreement (OMA) and voluntary export restraint (VER). In these, one country gets restricted import volume, the other gets supported export prices.

[3]Lester C. Thurow, *The Zero-Sum Society* (New York: Basic Books, 1980).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Moreover, if the agreement covers an intermediate product (e.g., steel), there is an advantage in the sale of finished goods (e.g., autos, made with lower-priced Japanese steel). The evolution of the OMA and the VER have turned retaliation into fertilizer for import restrictions, not insecticide. I am reluctant to laud the skills of our trade negotiators. It takes no particular craft to induce firms to do what the antitrust laws try to prevent them from doing voluntarily.

Reciprocity? Irrelevant to the rules-defined procedures for administered protection. Though imposing and removing import restrictions are, in economic logic, opposite directions on the same scale, they are in government completely different processes. What makes good economics a political force in one process is not built into the other one.

Revealing the Costs of Protection

The three Rs of the GATT—rules, retaliation, reciprocity—are not principles from which a solution to contemporary problems can be distilled. We need another idea—not necessarily a new one, just one newer than mercantilism. The idea is that there are mutual gains from free trade and costs of protection. An obvious task is to begin a process to create a greater public awareness of the domestic costs of protection, a process to educate the groups that bear the costs of their own government's protectionist policies, and thereby to help bring into the public mind a nonmercantilist sense of the gains from international trade. The problem is how to do it.

Harry Truman was fond of saying, "I never give the opposition hell, I just tell the truth on them and they think it is hell." Merchants who face trade barriers in foreign markets they covet should ask themselves what they, not their governments, might do. Armed with Harry Truman's attitude and some calculations of the internal costs of the trade restrictions he faces (i.e., the costs to consumers in that market), an exporter could make his own case. For example, an Argentine meat packer might sponsor a TV commercial in Japan to show an Argentine family enjoying a big roast beef and to show Japanese families how much of that roast beef they would have after the Japanese government took its slice.[4] Estimates of the internal costs of protection are available. It just takes a good ad agent to bring them to life.

At present we have bureaus and commissions to determine the costs to domestic producers of import competition. If exporters,

[4]For other examples, see J. M. Finger, "Incorporating the Gains from Trade into Policy," *The World Economy* 5 (December 1982): 367–78.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

following their own self-interest, created a public awareness of the *gains* from import competition, there might arise pressures for similar bureaus and commissions to determine savings to other industries that use imported inputs and to consumers. The community of professionals should see in this strategy many opportunities for gain. User industries could become clients just like import-competing firms. And if there is money to be made from it, the professionals might find ways to organize consumer interests. (It might be too much to ask that the commissions identify the costs and benefits of the proposed government action rather than of import competition.)

One result would be a more balanced presentation to society of gains and losses. When we take up international trade now, Ringling Brothers with all their company stage the show of costs, while outside the tent a 28-year old econometrician with a calculator and a blackboard explains the benefits. The policy professionals would be pitched more directly against each other over a diminishing number of conflicts that would become political matters. (Remember, the political system abhors a fair fight.) Under this pressure, they might overcome the instinct that preserves their species, and like the calico cat and the gingham dog, eat each other up and be gone.

The Role of Economists

What role is there in this for the economists? It is too much to ask that they do something good, but perhaps we can bring them to a basic standard of the medical profession—that their medicines do the economy no harm. Let them refrain from building models in which, in the name of Pareto, the blessings of nature must be offset by political interventions. Let them look instead for instances in which mankind would be better off if the means for these interventions had never been invented.

The lesson we must keep in mind is that the problems that trade issues deal with are not analytically complex, though they might be politically difficult. The complication that is associated with them is not analysis; it is alibi—the product of an instinct to avoid the political difficulty. The lesson, in short, is that if complexity did not exist, the politicians would have to invent it. Which is exactly what they did in the case of liberal trade policy.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"THE POLITICAL ECONOMY OF TRADE POLICY": A COMMENT

Subroto Roy

Michael Finger has given us a most engaging paper.[1] The fundamental paradox he sets before us is one that is both ancient and simple to state. The intellectual case for free trade and against mercantilism appears clear, compelling, and conclusive. From Adam Smith, Ricardo, and Torrens to Haberler, Heckscher, and Ohlin, it has been among the most obvious contributions that economics has made to objective knowledge. Yet, at the same time, nowhere is the academic economist more at a loss in explaining to his students how it is that the theory on the blackboard and the reality outside the window are so widely at odds with one another. For, in practice, it appears almost always and everywhere that it is the argument for free trade that has to be made over and over again.

There are, it seems to me, two ways to respond to this paradox. The first is to think that the theory must be mistaken, or at least that the descriptions the theory is based upon are seriously incomplete. The second is to think that there are dark forces of power and interest that prevent truth and reason from coming to light. Mr. Finger's arguments seem to tilt heavily—perhaps too heavily—toward the second explanation.

He offers us a vivid picture of society. On the one hand is the Great Anonymous Consuming Public, consisting of the multitudes of grocers, bricklayers, watchmakers, carpenters, truck drivers, cooks, shop assistants, plumbers, and so on. On the other hand is the tiny group of the educated and the powerful whom Mr. Finger calls "the policy community." Within this community are first, the academic economists who teach and publish in the field of international trade, and

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Assistant Professor of Economics at Virginia Polytechnic Institute and State University, Blacksburg, Va. 24061.

[1]"The Political Economy of Trade Policy," *Cato Journal* 3 (Winter 1983/84): 743–50.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

second, the trade policy professionals. This latter group consists of lobbyists, who are paid by various coalitions of domestic interests to persuade, tempt, or cajole politicians to look kindly at their particular cause, and colorless, equivocating government officials, who are less concerned with questions of truth or falsity than with papering over differences and pleasing all sides at any cost.

The picture of a tiny ruling class, or "policy community," extracting rents from, and enjoying the good life at the expense of, the public at large is one that is shared, interestingly enough, by both the libertarian and the honest Marxist. While it is a depressing picture, I am prepared to accept it as accurate in important respects and as a reminder of the neoplatonism of our times. In another respect, however, it is a somewhat romantic picture, in which the damsel is helpless in the clutches of the dragon and needs to be saved by the heroic knight.

Mr. Finger strongly implies that the main responsibility for the full gains from international trade not reaching the general public lies with the policy community. In particular, he notes that although the U.S. International Trade Commission must investigate any adverse effects of imports on domestic producers in import-competing industries, it is evidently not authorized to investigate the *benefits* of imports to domestic consumers. As a result, an absurd bias exists in the recommendations that public officials receive regarding whether or not imports of a particular commodity should be restricted.[2] It is this absurdity that Mr. Finger protests.

The dice have been loaded against free trade and in favor of protectionism by the fact that the liberalization of trade is a slow process requiring complex negotiations among many nations, while the restriction of trade is more easily accomplished by administrative fiat in response to domestic political pressure. Mr. Finger thus recommends—and I have no doubt rightly—that the dice be fair, that the absurd asymmetry in the advice received by an administration be removed. What this requires, according to Mr. Finger, is the creation of *other* government bureaus and commissions charged with reporting the benefits of trade, in order to balance the influence of those bureaus and commissions that presently report only the costs of trade.

Surely the recommendation should be slightly different. All that need be called for is that *existing* agencies report the benefits of trade liberalization. Could not a commission with the words "International Trade" in its title be expected to report the benefits of trade as well

[2]On this same point, I have benefited from J. M. Finger's earlier paper, "Incorporating the Gains from Trade into Policy," *The World Economy* 5 (December 1982): 367–78.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

as the costs? What we do not need, it seems, is even more bureaus and commissions—even ones with names like "The Bureau of Free Trade" or "The Commission on Consumer Gains," whose job advertisements would have to say that only free traders need apply. Surely, the absurd bias against which Mr. Finger protests can be rectified without expanding the existing bureaucracy.

I now want to return to the picture of the Great Consuming Public being taken for a ride, so to speak, by the unholy triad of ivory-tower economists, self-seeking lobbyists, and colorless officials. I think Mr. Finger has been too harsh on the triad and too easy on the public.

Samuel Johnson reputedly observed that "there are few ways in which a man can be more innocently employed than in getting money." If lobbyists are making small personal fortunes petitioning for or against import-relief measures, and if there are no legal barriers to entry into their occupation, then it really does seem to be as innocent an activity as any. Of course, such an activity can be thought to be "socially wasteful" insofar as it diverts the energies and abilities of many highly capable people toward unproductive activities. But if the rules of playing this political game provide powerful incentives to make money by playing it, then we should not be surprised to see individuals engaging in rent-seeking behavior in the capital city. As to government officials being bland and equivocating, at least in public, one might argue that such behavior is more often a virtue than a vice when one has chosen to make a living in a bureaucracy.

The task of making a living by publicly distinguishing truth from falsity, and of preserving the former and exposing the latter, falls mainly to academicians and the press, at least in free societies. Mr. Finger dismisses the academic trade theorists as irrelevant and sterile. In this he is partly wrong and partly right. Outstanding work has been done by distinguished academic trade theorists over the last 15 years, especially in the United States. The problem of determining the effective rate of protection, and the analysis and consequences of alternative foreign trade regimes in low-income countries, have both received widespread attention. On the other hand, it is perfectly true that there have been strong incentives for the modern economist who desires rapid academic success to be concerned with anything but reality. Achieving academic success means the economist must have a Ph.D., and then maximize the length of his curriculum vitae as quickly as possible to get promotions, pay raises, and tenure—even if that might mean being obscure, unoriginal, uncritical, or trivial. Above all, an academic economist must not be controversial. But controversial is exactly what he will have to be if he tries to take and describe reality seriously.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Thus, I am neither surprised nor appalled by the fact that the lobbyists are self-seeking, that officials are often equivocating, or that academic economists are prone to irrelevance. An economic analysis of such phenomena would look not so much at these actual outcomes as at the private incentives which are being acted upon and which are engendered by the particular rules of the game.

This leaves finally the "responsibility" of the public at large to be discussed. Mr. Finger makes a very interesting observation that the perception of the public as to what constitutes good trade policy is more often than not mercantilist: exports are good; imports are bad. I would not be surprised if a study of the history of public opinion on the question of what constitutes good trade policy (if such a thing can be written) showed that mercantilism has always been the dominant perception and free trade has always been viewed with suspicion. Does this imply that the public is grossly ignorant and should be taught the doctrine of comparative advantage? I think not. That would be at best only a part of the answer.

The costs of trade liberalization are immediate and tangible, and are perceived as such. Domestically produced goods are displaced by better-quality or less-expensive imports. Domestic firms manufacturing these goods are in immediate difficulties. In significant parts of the country there are a multitude of layoffs and loss of incomes, leading to falling expenditures and further loss of incomes, blighted towns and lengthening dole queues—with the television cameras zooming in to record it all for the evening news. There is definite and real pain and hardship involved for large numbers of men and women who may have had nothing whatsoever to do with the decisions that restricted imports in the first place. In such a milieu, it would be a poor and risky sort of joke to murmur that, "Well, after all, the cheaper imports are allowing consumers all over the country to achieve higher levels of utility"—true as this will be.

Liberalizing trade logically entails changes in the domestic division of labor. Some jobs will most definitely be lost, while others will appear. If I am reasonably sure that trade liberalization will destroy *my* job and force me to auction my house, then it may be perfectly rational for me to be pro-mercantilist, regardless of my expected gains as a consumer. In other words, mercantilist perceptions in public opinion can be seen as the rational response of economic agents who are averse to risk. These individuals will prefer the certainty of a job in hand plus high-priced, low-quality domestic goods to the uncertainty of employment plus low-priced, high-quality imported goods. This is by no means a defense of protectionist

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

policies, but a hint toward an explanation of why the public may resist trade liberalization.

In sum, I am inclined to eschew the picture of the general public as the damsel in distress who must be saved from the "policy community" dragon. Instead, I am inclined to suggest that the social outcomes we observe are—for better or worse—usually "equilibrium" outcomes, in the sense that the economic agents whose beliefs and actions resulted in the observed outcomes may have little or no incentive to change them. That, in turn, may help explain why when the theory on the blackboard cries out that reform should occur, the scope for reform is in practice so limited.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

U.S.-JAPANESE TRADE: MYTHS AND REALITIES

Steve H. Hanke

Our opponents have adopted a tactic that puts us in a most embarrassing position. When we expound our doctrine, they accept it in the most respectful manner possible. When we attack their principles, they abandon them with the best grace in the world. They ask only that our doctrine, which they accept as true, be relegated to books, and that their principles, which they admit to be faulty, constitute the rule in the realm of practical affairs. Grant them the management of tariffs, and they will leave to you the domain of theory.

—Frédéric Bastiat, *Economic Sophisims*

Introduction

Even though more than a century has passed since Frédéric Bastiat faced the interventionists' refrain, little has changed. Free-traders are still told that their principles are correct but that free trade, as a policy, is impractical and politically unattainable.[1] By examining the myths and realities of trade relations between the United States and Japan, we will be able to demonstrate that free trade with Japan would be mutually beneficial and politically possible.

Before beginning our demonstration, we will review the free-traders' principles. Free trade is ultimately based on private property

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of Applied Economics at The Johns Hopkins University, Baltimore, Md. 21218. He also serves as a Senior Economic Advisor to the Joint Economic Committee of the U.S. Congress, and is a Senior Fellow at the Manhattan Institute for Policy Research in New York City.

[1]Charles N. Stabler, "How Economists Think About World Trade," *Wall Street Journal*, 28 November 1983.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

and individual liberty. If free trade is restricted, sellers and buyers have their liberties restricted. In addition, they have some of their property taken. The transferability of property is a necessary condition for an efficient system of property rights. By hindering the transferability of property, trade restrictions hinder the movement of resources from less to more valuable uses. Consequently, restrictions on voluntary exchange cause a reduction in the value of property owned by sellers. In addition, restrictions reduce the wealth of buyers. By reducing the value of sellers' property and buyers' wealth, restrictions result in the taking of property by the state and also economic waste.

Although private property and individual liberty are often overlooked in trade policy debates, they remain the bedrock upon which free trade rests. Respect for private property and individual liberties will result in free trade, and economic benefits will ensue: Products that have the greatest cost advantage, when compared to their production cost in other countries, will be produced for export. Therefore, from an economic point of view, free trade will put in place dynamic forces that move resources out of industries with the lowest productivity and into those with the highest productivity.

Protectionist Sentiment and U.S.-Japanese Trade Relations

The protectionists in the United States have thrown the principles upon which free trade rests into the academic dustbin. They are interested instead in the fact that the United States is running a deficit in its merchandise trade account. And, in particular, they tend to focus their concern on Japan, a country with which the United States has a deficit. For example, in the period 1976–83, the United States incurred a cumulative trade deficit—primarily as a result of Japanese penetration into U.S. markets for textiles, television sets, automobiles, motorcycles, radios, photographic equipment, video tape recorders, watches, machine tools, and steel—of about $95 billion.[2]

The protectionists' general argument is captured by a recent (August 29, 1983) *Business Week* cover story, "America's Hidden Problem: The Huge Trade Deficit Is Sapping Growth and Exporting Jobs." As the title implies, protectionists argue that U.S. jobs are lost when we incur a trade deficit, and that this is something we should avoid. Japan has become the specific "whipping boy" of the U.S.

[2]Council of Economic Advisers, *Annual Report* (Washington, D. C.: Government Printing Office, 1984).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

protectionists because we have a trade deficit with them and, perhaps more important, because we have been victimized by what are alleged to be "unfair" trade practices. The protectionists argue that U.S.-Japanese trade policies are asymmetric. They claim that the U.S. markets are "open" to the Japanese while Japan's markets are "closed" to the United States.[3]

The protectionists' argument is buttressed by the following complaints, which are directed at the Japanese:[4]

- Product design standards and their administration are intended to restrict the entry of U.S. products into the Japanese markets.
- Japanese importers must cut through unnecessary red tape to obtain permission to import U.S. products.
- Tariffs—particularly on finished lumber, tobacco, paper, computer parts, chocolate, and leather—inhibit U.S. exports to Japan.
- Import quotas and their administration restrict U.S. exports to Japan.
- Direct foreign investment in Japan is difficult because Japan's policies are not clear and foreign investors are not accorded the same treatment as Japanese nationals.
- Japanese capital markets are restricted and heavily administered by the state.
- "Targeted industries"—particularly beef and citrus—are shielded from outside competition by Japan.
- Other "targeted industries" are awarded special favors by Japan, and this gives them on unfair advantage to penetrate the U.S. market.

Given these complaints—which, indeed, have merit, in varying degrees—and the rising protectionist sentiment in the United States, we have reacted with relatively mild, but potentially destructive, protectionist measures. "Voluntary" quotas for automotive vehicles were agreed to, and restrictions were placed on some types of steel, motorcycles, and several other products. But, to its credit, the Reagan administration has resisted other proposals for protectionist policies that would restrict Japan's ability to trade with the United States.[5]

[3]"America's Hidden Problem: The Huge Trade Deficit is Sapping Growth and Exporting Jobs," *Business Week*, 29 August 1983.

[4]William E. Brock, "Japanese Trade Barriers," a memorandum for the president, 18 December 1981.

[5]Herbert Stein, "U.S. Foreign Trade and Trade Policy," *The AEI Economist* (July 1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

A New U.S. Strategy

Time is running out for President Reagan and his strategy to maintain free trade with Japan.[6] If the Reagan administration wants to keep holding back the protectionist sentiment in the United States, the president can no longer afford to just list our grievances with Japan and request that the Japanese redress their protectionist policies. It is time to drop the "we are right and you are wrong" approach to our trade relations with Japan. This approach, at best, can yield nothing more than minor concessions by the Japanese and more protectionist measures by the United States.

The president must begin to act as a statesman and leader. He must unilaterally offer the Japanese a policy that they cannot refuse and also one that will benefit the United States. This can be accomplished by realizing that Japan's economy depends on imports of raw materials. For example, the Japanese experience a trade deficit in all major categories of primary products. The Japanese process these raw material imports into manufactured goods for domestic consumption and export. Exports of finished products are, indeed, very large. This is attested to by the fact that the Japanese incur a trade surplus in all major categories of manufactured goods. In short, the Japanese economy has evolved to import raw materials and export finished goods. This is how the economy adjusts to its comparative advantage.

Even though there might be some merit in the argument that the Japanese markets are "closed" to the United States while our markets are "open" to the Japanese, this argument does not reveal the entire picture. The unrevealed portion of the picture is one in which U.S. law forbids the shipment of certain raw materials—which represent the imports that the Japanese desire and would welcome—to Japan. Therefore, while Japanese laws, regulations, and customs act to restrict the entry of some U.S. goods to Japan, the major restrictions on U.S. exports to Japan are the result of U.S. laws that prohibit U.S. individuals and firms from exporting raw materials to Japan. Specifically, oil produced in Alaska is, in effect, totally restricted and logs cut on federal lands are banned from being exported to Japan.

The message President Reagan should deliver to the Japanese is a simple one: His administration should propose legislation that would lift the restrictions on Alaskan oil exports and the bans on federal log exports. The president's proposals should be made unilaterally, with no conditions attached.

[6]Mike Tharp, "The Stalemate Lingers," *Far Eastern Economic Review*, 22 September 1983.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Alaskan Oil

In January 1968, significant reserves of oil and gas were discovered at Prudhoe Bay on Alaska's North Slope (ANS). Following the ANS discoveries, there was much congressional testimony and debate about alternative plans for transporting oil and gas to market. Finally, in 1973, the Trans-Alaska Pipeline Authorization Act was passed. This act allowed for the construction of a pipeline across federally owned lands, from the ANS to southern Alaska, where crude oil would be loaded on tankers at the port of Valdez and shipped to market. This act included the requirement that any exports to noncontiguous countries, such as Japan, receive presidential approval.

The Trans-Alaska Pipeline Authorization Act established two criteria for determining whether exports would be allowed: (1) the president must conclude that exports "would not diminish the total quantity or quality of petroleum refined within, stored within, or legally committed to be transported to and sold within the United States"; and (2) if the president makes such a determination, then he is required to report his findings to Congress, who can overturn the presidential initiative by passing a joint resolution within 60 days.

If this were not enough, the 1977 and 1979 amendments to the Export Administration Act (EAA) placed additional restrictions on the export of oil to noncontiguous nations. For example, the 1979 amendments require Congress to confirm any presidental proposal to export oil.

The restrictions contained in the Trans-Alaska Pipeline Authorization Act and the Export Administration Act make it virtually impossible to export oil from Alaska to noncontiguous nations.[7] The Japanese are particularly hit hard by this fact, since they import almost all of their oil and Alaska would be their least-cost supplier under free-trade conditions.[8]

The Political Economy of Alaskan Oil

To understand why the United States has restricted the export of Alaskan oil, we must identify the major special-interest groups who advocate restrictions and grasp the nature of the benefits they derive from interventionist policies.

The maritime industry, environmentalists, some consumer groups, and others with an interest in national security represent the special

[7]S. Fred Singer, Milton Copulos, and David J. Watkins, "Exporting Alaska's Oil and Gas," Heritage Foundation *Backgrounder* No. 248, 22 February 1983.

[8]John S. DeMott, "At the End of a Floating Pipeline," *Time* (Special Issue): *Japan a Nation in Search of Itself*, 1 August 1983.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

interests that have teamed up to support restrictions on the export of Alaskan oil. The maritime industry (seamen's unions and domestic shipbuilders) derives its interest in supporting restrictions on the export of Alaskan oil from the Merchant Marine Act of 1920, which is commonly known as the Jones Act. The Jones Act mandates that waterborne commerce between U.S. ports be carried out in U.S.-built, owned, registered, and manned ships. Thus, to the extent that the maritime industry can successfully propose and support legislation that limits the export of U.S. goods, it can—to the extent that these goods are traded in the United States and transported by water after the export limits—artificially increase the demand for U.S. seamen and ships.

The maritime industry's actions to support restrictions on the export of Alaskan oil have paid large dividends. Currently, more than 90 percent of the U.S. flagship capacity, measured in deadweight tons, is committed to carrying oil from Alaska to U.S. ports.

The environmentalists generally adopt a "Mother Hubbard" view of natural resources. As they see it, there is a fixed quantity of various natural resources. According to the environmentalists, our standard of living will decline rapidly as the various natural resource cupboards become bare. Given this view, the environmentalists have supported restrictions on the export of Alaskan oil because they believe these restrictions will slow down—if not stop—the development and use of Alaska's natural resources.

Consumers' support for export restrictions on Alaskan oil derives from their belief that keeping oil in the United States will make oil prices lower than if exports were allowed. National security enthusiasts also support restrictions. In their view, the goal of building a self-sufficient oil supply will guarantee U.S. immunity to supply disruptions caused by foreign wars and embargoes.

Faulty Special-Interest Pleadings

The arguments favoring Alaskan oil export restrictions are fatally flawed. The maritime industry's pleadings are perhaps the most clear-cut case of a special-interest group arguing for a government bailout. It is true that the restrictions on exporting Alaskan oil have benefited maritime interests. But the costs created are large and outweigh the gains derived by the maritime industry.[9] The owners of Alaskan oil, for example, bear a large portion of these costs. The value (the

[9]Beth deHamel, James R. Ferry, William W. Hogan, and Joseph S. Nie, Jr., *The Export of Alaskan Crude Oil: An Analysis of the Economic and National Security Benefits* (Cambridge, Mass.: Putnam, Hayes, and Bartlett, Inc., 1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"wellhead" price—the market price minus transportation costs) of Alaska's oil assets is reduced by restrictions on exports, since producers are required to transport their products in high-cost U.S. tankers to uneconomic destinations in the United States.

With the market price of oil a given, higher transportation costs mean lower net receipts at the wellhead and a lower value on Alaskan oil. That this reduction in the value of Alaskan oil occurs is evidenced by the fact that transport charges per barrel of Alaskan oil are $0.90 higher if the oil is shipped to the West Coast of the United States and $3.70 per barrel higher if the oil is shipped to the Gulf Coast, rather than to Japan.

By reducing the wellhead price for Alaskan oil, the restrictions mean that the incentives to explore for and develop more Alaskan reserves are reduced. Ultimately, this means less oil will enter the world oil market, and less competitive pressure will be put on OPEC's control of crude oil prices. Consequently, restrictions on the export of Alaskan oil strengthen OPEC's hand, which is another cost of the restrictions. Pure economic waste also accompanies the inefficient distribution of Alaskan oil and is a further cost of restricting Alaskan oil exports to Japan. This waste is equal to the delivered price at U.S. ports of Alaskan oil minus the delivered price at the same ports of oil imported from foreign sources.

Consumers' arguments favoring export restrictions on Alaskan oil are totally without merit. Consumers do not enjoy lower prices when the oil they consume is delivered from Alaska rather than elsewhere. Oil is sold in competitive markets. Hence, supply and demand conditions, and not oil's source, determine (with some minor exceptions, resulting from the pricing policies of various OPEC countries) its price in the short run. In the long run—with less Alaskan oil being explored for and developed because of restrictions—consumers will actually pay higher oil prices, since less oil will be put on world markets with restrictions than without them.

If the environmentalists' "Mother Hubbard" view of natural resources was correct, the real costs of natural resources, including oil, would have been increasing over time. Analyses of the facts, however, refute the environmentalists' theory of natural resource scarcity. The long-term costs of energy, for example, have been falling, and this means that energy is becoming less, not more, scarce. Consequently, the environmentalists' rationale for government intervention to save us from running out of oil and other natural resources is unsupportable.[10]

[10]Julian L. Simon, *The Ultimate Resource* (Princeton, N.J.: Princeton University Press, 1981).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The national security alarmists' arguments, which favor export restrictions on Alaskan oil, are also flawed. Export restrictions will not promote energy security. In fact, restrictions will impede the attainment of energy security. By restricting Alaskan oil exports, the United States forces Japan, a strong ally in the Far East, to depend almost totally for its oil supplies on OPEC producers from the Middle East. If we supplied Japan with some of its oil, Japan's sources would be more diversified, and our important ally would be more secure in its energy supply. This, in turn, would help, not hinder, the overall security position of the United States.

The national security advocates should remember that they have, in a slightly different context, recognized the advantages of diversified sources and "trade" in oil. This is why they have been proponents of continued U.S. membership in the 21-nation International Energy Agency. Terms of membership in the group call for a sharing of U.S. oil with other members in times of emergency. Thus, although the national security proponents favor no trade in Alaskan oil during peacetime because it promotes our energy security, they argue that during emergencies forced "trade" should be mandated to ensure our security. The fact is that they have never quite gotten their facts and analysis straight. They should realize that free trade and the diversification of supplies that will result will enhance our security position.

Free trade and the export of Alaskan oil would also eliminate the pure economic waste, which was referred to earlier and exists in the current restricted trading system. The elimination of the considerable waste will benefit both the Japanese and the U.S. economies. This, too, will help, not hinder, the overall security position of the United States.

Again, we should not forget that our overall security would be enhanced by free trade and the consequent increased value of Alaskan oil. For, this increase in value will result in more exploration and development of Alaskan oil, which will result in more crude oil entering world markets. This will weaken OPEC's position and improve our overall national security.

Federal Logs

To appreciate why demands are made to continue a total ban on the export of unfinished logs cut on federally owned lands and why the arguments supporting the bans are unfounded, we must first

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

understand something about the nature of the U.S. timber industry.[11] The nation contains 488 million acres of commercial forest land. This is equal to about 25 percent of the land area of the continental United States. Table 1 contains a breakdown of U.S. commercial forest lands, classified by regions and types of ownership.

The concentration of public forest lands in the West is a result of the direction of United States settlement from east to west and land disposition policies. Land disposition policies were designed to

TABLE 1

U.S. COMMERCIAL FOREST LAND
BY REGION AND OWNERSHIP, 1977
(Millions of Acres)

Region	National Forests	Other Public	Forest Industry	Other Private	Total Percent*
North	10.1	21.2	17.8	121.6	170.7
Percent	6	12	11	71	35
South	11.0	6.7	35.8	134.9	188.4
Percent	6	3	19	72	38
Pacific	31.5	12.9	12.3	14.1	70.8
Percent	45	18	17	20	15
Rocky Mtn.	36.4	6.8	2.1	12.5	57.8
Percent	63	12	4	21	12
U.S. Total	89.0	47.6	68.0	283.1	487.7
Percent**	18	10	14	58	100

*Percent of U.S. total by region.
**Percent of U.S. total by ownership.
SOURCE: U.S. Department of Agriculture, U.S. Forest Service, *Forest Statistics*, 1978.

NOTES: The rows in Table 1 show millions of acres and percent of total U.S. commercial forest lands by region and owner. In the North region, for example, 121.6 million acres, or 71 percent, of the total 170.7 million acres of commercial forest land is owned by the "Other Private" class of owners. Forest land owners in this class grow and sell timber, but do not, in general, engage in wood processing. Total commercial forest acreage in the North region amounts to 35 percent of the U.S. total.

Figures in the columns of Table 1 indicate regional acreages by ownership. For example, the column under "National Forests" indicates that total commercial acreage on the national forests is 89.0 million acres, or 18 percent of the U.S. total, and that 45 and 63 percent of the forest land areas, respectively, in the Pacific and Rocky Mountain regions are in the national forests.

[11]Barney Dowdle and Steve H. Hanke, "Public Timber Policy and the Wood-Products Industry," in *Forest Lands, Public and Private*, ed. M. Bruce Johnson and Robert Deacon (Cambridge, Mass.: Ballinger Publishing Co., 1984).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

implement private ownership during the nation's formative years. These policies were changed to promote public ownership, especially of timberlands, around the turn of the century. Consequently, many of the lands in the West, which were settled last, remained in public ownership.

Commercial forest lands, while important from the standpoint of future timber supplies, do not necessarily indicate where lumber and plywood will be produced in the near term. Sources of supplies of these solid-wood products will be determined for the next several decades, in large part, by the location of existing inventories of mature softwood sawtimber (see Table 2). While most of the commercial forest land is in private ownership (72 percent), the public sector currently owns most of the mature softwood sawtimber (63 percent). The national forests alone contain over half (51 percent) the total inventory.

The disparity between the public ownership of commercial forest land (28 percent) and public ownership of mature timber (63 percent) arises because past timber harvests were concentrated in the private sector. For example, during the first 50 years of their existence (1905–55), the national forests contributed about 3 percent to total softwood timber output.

TABLE 2

SOFTWOOD SAWTIMBER INVENTORIES
BY REGION AND OWNERSHIP, 1977
(Billions of Board Feet, Int. ¼-Inch Log Scale)

Region	National Forests	Other Public	Forest Industry	Other Private	Total Percent*
North	7.1	12.8	23.1	54.2	97.1
Percent	7	13	24	56	5
South	33.8	13.9	87.3	204.9	340.0
Percent	10	4	26	60	17
Pacific	706.4	166.1	175.8	116.9	1,165.4
Percent	61	14	15	10	59
Rocky Mtn.	260.8	42.7	23.3	53.5	380.4
Percent	69	11	6	14	19
U.S. Total	1,008.1	235.6	309.5	429.5	1,982.8
Percent**	51	12	16	21	100

*Percent of U.S. total by region.
**Percent of U.S. total by ownership.
SOURCE: U.S. Department of Agriculture, U.S. Forest Service, *Forest Statistics*, 1978.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

As a result of past timber harvests originating primarily in the private sector, much of the private timber inventory now consists of immature timber which was established on previously cutover lands and will not reach maturity for several years. In the interim, the wood-processing industry will be heavily dependent upon public timber supplies. Likewise, public timber policies, which played a minor role in the past, will play a significant role in the future.

The size and timing of public timber offered are indicated by policies that are largely unrelated to market conditions. The practice of "sustained yield" forestry dominates public forestry. This practice means that only the annual increment in a forest's growth can be cut in any year. As a result, cutting on mature public forests is very small and inventory adjustments are difficult to make. In addition to this severe constraint on the volume of public timber that is allowed to be marketed, the industry also faces additional problems in obtaining timber from public forests because many public forests are being withdrawn completely from commercial use.

From an economic point of view, government agencies are attempting to manage timber, which is a capital asset, without counting capital carrying charges on the assets they hold. This results in too little current output and the holding of too much inventory.

An important consequence of the Forest Service's faulty inventory policy is that supplies of timber are not being made available to meet timber demands during the private sector's transition from virgin timber to "second-growth" timber supplies. By restricting supplies, the Forest Service is creating an artificial timber famine.

The Political Economy of Federal Logs

As a result of the government's creation of an artifical timber famine, special interests demanded an embargo on logs produced on public lands. These demands were met in 1968, with an amendment to the Export Administration Act. This so-called "Morse Amendment" dictated that timber cut from federal lands must be subject to primary processing prior to export. In addition, the amendment contains a substitution provision that disallows "substitution." That is, a firm that owns private timber cannot export unprocessed logs off its private land and then purchase federal timber for processing in its domestic mills.

The timber and wood-products industry has collaborated with environmentalists to support the ban on the export of federal logs. Those who own sawmills and depend on logs cut on federal lands for their raw material do not want federal logs exported. As they see it, the export prohibition helps to keep domestic log prices lower

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

than they otherwise would be. Timber companies owning large acreages of private timber that are not subject to the export ban also like it. For these log exporters, the ban means less competition in international log markets. In addition, the wood-products industry supports a log export ban because it wants to export finished products, not logs. It sees the ban as a way to force foreigners to purchase finished goods, rather than logs.

The environmentalists, too, view the prohibition on log exports favorably. They believe that the export ban is a way to reduce the quantity of logs cut on timber-rich federal lands on the West Coast and in Alaska. Given their "Mother Hubbard" theory of natural resources, any policy that reduces the use of natural resources is a good policy.

Faulty Special-Interest Pleadings

The primary argument used by all special interests to support the ban on the export of federal logs has been the alleged timber famine in the United States. The timber famine, which gives rise to the demand for bans on federal log exports, is not real. In fact, the United States presently has a larger total inventory of commercial timber than it did at the turn of the century.[12] To the extent that we have a famine, it is artificially created by federal restrictions on the annual allowable cut on public forests. To correct for this, the government should either privatize its commercial timberlands or change its method of determining the annual amount of timber that can be cut.

The other argument that is used to support the log export ban is that we can generate more employment and value-added in the wood processing industry by exporting finished products, not logs. This argument can only work if we have monopoly power in the market for finished products. But we do not have such a monopoly. By not exporting federal logs to feed the 20,000 mills in Japan, we have reduced employment in the timber industry because Japan has switched to other log suppliers.[13] Therefore, because of the ban, we do not even obtain the employment that would be generated by cutting and shipping logs to Japan.

Conclusion

To break our trade stalemate with Japan, and promote free trade and improved U.S.-Japanese ties, President Reagan should make a

[12]Sherry H. Olson, *The Depletion Myth: A History of Railroad Use of Timber* (Cambridge, Mass.: Harvard University Press, 1971).

[13]Erick Larson, "Logging Sales," *Wall Street Journal*, 7 May 1982.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

unilateral offer that his administration will propose legislation to eliminate the existing, self-imposed embargo on the shipment of Alaskan oil and federal logs to Japan. This would not only increase the value of these natural resources and U.S. employment, but would also reduce our merchandise trade deficit with Japan. For example, oil exports could eventually grow to $15 billion annually,[14] and federal logs to $1 billion annually.[15] This alone would almost eliminate our trade deficit with Japan.[16]

By putting the interest of the nation ahead of narrow special interest, President Reagan would be able to satisfy his most ardent free-trade supporters and, for that matter, most of the public. At the same time, he would be able to silence neo-mercantilist critics who fret over bilateral trade imbalances. Moreover, such a bold move by the president would, no doubt, produce concessions from the Japanese.[17]

[14]Beth deHamel et al., *Export of Alaskan Crude.*

[15]Steve H. Hanke, "Timber Sales to Japan,' a memorandum to the Honorable David Stockman, 7 January 1982.

[16]It is important to mention that, although bilateral trade balances have no particular economic significance, they can have great political significance. This is the case with our trade balance with Japan. Therefore, if the promotion of free trade with Japan will reduce our trade deficit with the Japanese, a stronger political case for free trade can be made by mentioning the trade-deficit reduction impacts of the proposed free-trade policies.

[17]Yoshisumi Matsuda, "Japanese Market More Open than U.S. Thinks," *Los Angeles Times,* 26 September 1983; and U.S. Embassy in Tokyo, "Government of Japan Announces External Economic Measures Program to Reduce Trade Surplus," a cable (22589) to the Secretary of State, 16 December 1981.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"U.S.-JAPANESE TRADE": A COMMENT

Gary Hufbauer

The Japanese Trade Debate

Professor Hanke has come up with a new and refreshing proposal—no small accomplishment in the realm of policy commentary.[1] With this proposal, Professor Hanke has joined a minority school that says the United States spends too much time worrying and whining over Japanese trade practices. A second member of that school is Gary Saxenhouse, who argues that the Japanese have not closed their economy noticeably more than the Germans or Americans. A third member is Philip Trezise, who, over the years, has tried to moderate Washington passions about Japanese economic issues. I am sure there is a fourth member of the school, but his name does not spring readily to mind.

Opposed to the minority school is a large community of Japan watchers. When the full moon rises, some can be heard baying. In calmer moments, the majority school can recite abundant examples of Japanese trade restrictions that seem preposterous on their face—for example, on cigarettes, citrus, and beef imports—and restrictions that seem designed to undercut the Japanese government's nominal commitment to trade liberalization—for example, on semiconductors, machine tools, and pharmaceuticals.

Prompted by these bad examples, Lester Thurow recommended, early in 1983, that "we abolish all of our current restrictions on specific Japanese exports and replace them with a general system of reciprocity."[2] John Maynard Keynes once remarked that political

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Senior Fellow at the Institute for International Economics, Washington, D.C. 20036.

[1]Steve H. Hanke, "U.S.-Japanese Trade: Myths and Realities," *Cato Journal* 3 (Winter 1983/84): 757–69.

[2]See the comment by I. M. Destler, "The Wrong Approach to Japanese Trade," *Washington Post*, 16 March 1983, p. A23.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

proposals often reflect the half-remembered ravings of a forgotten academic. In this instance, the time horizon was much compressed. In the 98th Congress, Representative Fortney Stark offered a bill that would have limited the bilateral U.S.-Japan deficit to $10 billion a year.

An interesting analogy can be drawn between the Japan trade debate and the disarmament debate:

- Most observers agree that both the United States and the Soviet Union would be better off with mutual disarmament.
- Most observers agree that both the United States and Soviet Union would be worse off if each were to accelerate its spending on armaments.
- But observers disagree, with much passion, as to whether one country, namely the United States, could improve its welfare by unilaterally reducing its arms expenditures, regardless of the response (in terms of arms spending) by the Soviet Union; or whether one country's unilateral reduction of armaments would prompt the other country to reduce its arms—at a faster pace or to a greater extent than might be accomplished through mutual agreement.

Parallel agreements and disagreements mark the commercial policy debate between the United States and Japan:

- Most observers agree that both the United States and Japan would be better off with a mutual reduction of trade barriers.
- Most observers agree that both the United States and Japan would be worse off if each were to escalate its barriers against the other's products.
- But again there is passionate disagreement as to whether one country, the United States, could improve its welfare by unilaterally reducing its own trade barriers, even if there was no liberalizing response in Japan; or whether one country's unilateral liberalization would prompt the other to reduce its barriers—at a faster pace or to a greater extent than would be achieved by negotiation.

The Hanke Proposal

In this debate, Professor Hanke takes the high road: He argues for unilateral U.S. trade liberalization, regardless of the Japanese policy response. Underlying Hanke's strategy is a bold political arithmetic. By eliminating restrictions on oil and log exports to Japan, the United States would, at the same time:

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

- Do itself an economic favor by realizing more from its natural resources;
- Realize this self-serving favor very much sooner than through the tedious process of negotiations; and
- Do the world trading system a political favor by reducing the bilateral trade imbalance between Japan and the United States by up to $15 billion a year, thereby removing a source of ill-informed, but very real, political tension.

Professor Hanke recognizes that his political arithmetic faces some hard practical realities. He can count on the certain opposition of the U.S. maritime unions, the chief beneficiaries of the present restrictions on oil exports to Japan; he can also count on the opposition of timber-deficient Western lumber mills and their associated unions, unless the U.S. Forest Service enlarges the permitted timber cut on public lands. In addition, Hanke's plan faces opposition from U.S. industry lobbyists and U.S. trade negotiators who want concessions from Japan. These lobbyists and negotiators would feel pangs of anguish if trade "chips" were simply "thrown away"—with no trade trophies from Japan to show in return.

On the theory that you can tell a good argument by its opponents, I think Hanke's package should commend itself to President Reagan.

Extending Hanke's Approach

I would like to explore a further question. Should Hanke's approach be extended to other trade barriers? Should the United States (or other countries) embrace a policy of unilateral disarmament of trade restrictions on imports as well as exports? This, of course, would represent a highly ambitious extension of Hanke's position.

The "con" arguments against an ambitious extension of the unilateral approach can be readily summarized. First, there is the argument that, even if the internal resource reallocation process works smoothly, the country that unilaterally liberalizes may take a beating on its terms of trade. The terms-of-trade argument is ultimately an empirical question, but I happen to think that the fear is greatly exaggerated. I find it difficult to believe that unilateral liberalization by the United States, to the extent of even $20 billion, would adversely affect the U. S. terms of trade by as much as 2 or 3 percent.

Second, there is the argument that a negotiated solution will produce better results. Mention is often made of the progress accomplished in seven rounds of GATT negotiations. My own belief is that negotiated progress has become increasingly labored. Analysis of the

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Tokyo Round by Deardorff and Stern[3] shows extremely meager gains from tariff cuts, and even those limited gains took a long time and many large side payments to achieve.

The third con argument concerns adjustment costs. It can be reasonably argued that resources freed up do not move quickly to new lines of employment—with the result that taxpayers are burdened with large social programs.

Fourth and finally, there is the fear that unilateral liberalization, as applied to sunrise industries, would give foreign industrial nations a leg up on economies of scale and learning curve effects. The liberal trade country will supposedly miss out on the early phases of the industry, when capital can be accumulated at rates of return upwards of 40 percent annually. This fear is widely believed, but poorly documented.

On the "pro" side, it can be argued that a policy of unilateral trade disarmament would accomplish two important things. First, it would enable faster improvement in resource allocation than the path of tedious negotiations can yield—provided that adjustment difficulties can be overcome. Second, it is just possible that unilateral trade barrier reduction, if practiced by two or three leading countries, would prove contagious, and break the prevailing logjam of protectionist sentiment.

These pro and con arguments lead me to suggest a new tactical approach toward trade negotiations. In the new approach, the United States (and like-minded countries) would implement unilateral trade barrier reductions. However, if those concession were not matched with satisfactory reciprocal concessions within a reasonable time period, they would be rescinded, on a *non* most-favored-nation (MFN) basis.

The magic of this tactical approach—if it has any magic—lies in the difference between birds in the hand and birds in the bush. It is a tactic for deliberately destabilizing the political balance—in Japan, in the European Community, in Mexico, and in other countries. It presupposes that exporting firms abroad would more energetically prompt their own governments to give a concession in return—if those firms could tangibly count the markets potentially at risk to third-country competitors through a non-MFN recision of the original concession. The fear of losing present markets should prove at least

[3]Alan V. Deardoff and Robert M. Stern, *An Economic Analysis of the Effects of the Tokyo Round of Multilateral Trade Negotiations on the United States and the Other Major Industrialized Countries*, study prepared for the Subcommittee on International Trade, Senate Committee on Finance, 96th Cong., 1st Sess., June 1979, pp. 92–108.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

as compelling in the quest for trade liberalization as the hope of gaining future markets.

Let me hasten to add that the country that pursues a policy of unilateral liberalization would need to pursue, simultaneously, active companion policies in two related spheres. First, liberalization—whether unilateral or reciprocal—critically depends on a policy of managing the exchange rate with an eye to the current account balance. The removal of trade barriers would be much more palatable to domestic producers if they could rely on macroeconomic policy to ensure that exports of goods and services approximately equal imports.

The second companion policy is a more active adjustment program. Elsewhere, Howard Rosen and I have explored this question.[4] The basic point is that political incentives should be changed so that declining industries are better rewarded by scaling down their activities than by erecting political barriers to preserve the status quo.

[4]Gary Clyde Hufbauer and Howard Rosen, "Managing Comparative Disadvantage," unpublished manuscript, Institute for International Economics, Washington, D.C., December 1983.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

THE HIGH COST OF PROTECTIONISM

Murray L. Weidenbaum

Introduction

The rising pressures from management and labor for protection against imports require a Dutch uncle response, one that takes a tough position for the listeners' own good. My conversation with many business executives and union leaders reminds me of the students who cut class, do not do their homework, and then complain when you give them a low grade. Unfortunately, the parallel is clear.

For instance, in the U.S. automobile industry, worker attendance is substantially less than in Japan. The typical plant absenteeism in Japan averages 1.6 percent, whereas in the United States it ranges from 7 to 11 percent.[1] In addition, the labor turnover rate in the United States is twice as high. In 1977 Toyota reported a turnover rate of 2 percent compared with the historical average of around 4 percent for domestic U.S. automobile firms.[2] Yet, although these inefficiencies can be corrected, labor and management still request protection from the strong foreign competition which is, to a large extent, a result of the differences in current cost structures.

A second example is that of Caterpillar Tractor, a company which is losing its share of world markets, and at the same time is required to pay a bonus each time a worker puts in a full week on the job. In

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Director of the Center for the Study of American Business at Washington University, St. Louis, Mo. 63130. He is indebted to Michael Athey for assisting in the preparation of this paper.

This paper draws heavily on Murray L. Weidenbaum with Michael C. Munger and Ronald J. Penoyer, *Toward a More Open Trade Policy*, Formal Publication No. 53, Center for the Study of American Business, Washington University, 1983.

[1]William J. Abernathy, James E. Harbour, and Jay M. Henn, "Productivity and Comparative Cost Advantages: Some Estimates for Major Automotive Producers," draft report to the U.S. Department of Transportation, Transportation Systems Center, 13 February 1981, p. 29.

[2]Ibid., pp. 34–35.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the recent contract settlement between the UAW and Caterpillar, the union "generously" agreed to replace the previous two hours time-off credit with a provision that allows workers to earn only one hour a week credit for regular attendance. Even with this concession, an average worker can still get paid for as much as four and a half days a year in which he or she does not work.[3] That is like my having to give an apple to each student who shows up in class on time. The result of contract settlements such as this has been to make it more difficult for American companies to compete with foreign firms. In this case, Caterpillar's labor costs are reported to be about double those of its major competitor, Japan's Komatsu Ltd.[4]

The sad truth is that industry after industry in the United States has been matching rising labor costs with falling productivity, making it more and more difficult to compete with imports. We cannot blame that on foreigners. The solution to this is not to erect additional trade barriers. Let us not fool ourselves about our hands being clean. The United States has erected numerous obstacles to imports. We may have conveniently short memories for such matters, but foreign businessmen can cite U.S. trade restrictions by chapter and verse.

Despite the lip service so often paid to the virtues of free trade, there is great danger that the United States is taking the lead in the current rush toward protectionism. Public policy debates are now dominated by one-sided, self-serving views of international trade. Everyone wants open markets and free trade overseas. We all know how urgent it is to eliminate "their" barriers to our exports. But we rarely even acknowledge U.S. barriers to foreign exports.

The problem can be explained with a simple, two-country example. Suppose country B has a big export surplus with country A while country A has a hard time getting its exports into country B. Sound familiar? Country B (with the big trade surplus), of course, stands for Japan and country A (with the big trade deficit) represents the United States. However, the story does not end here. When we take another look, we find that country B (with the big trade surplus) could also represent the United States and country A (with the big trade deficit), Western Europe. In fact, the United States has enjoyed a merchandise trade surplus with the European Common Market over the last decade ($83.8 billion) that is slightly larger than Japan's surplus with us ($81.4 billion). (See Table 1.)

[3]"A Strike-Weary Caterpillar Knuckles Under," *Business Week*, 2 May 1983, p. 30.
[4]Ibid.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

TABLE 1

COMPARISON OF U.S. MERCHANDISE TRADE WITH JAPAN AND WESTERN EUROPE
(Billions of Dollars)

Area	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Japan										
Exports	8.4	10.7	9.6	10.2	10.6	13.0	17.6	20.8	21.8	20.7
Imports	9.7	12.4	11.3	15.5	18.6	24.5	26.3	31.2	37.6	37.7
Deficit	−1.3	−1.7	−1.7	−5.3	−8.0	−11.6	−8.6	−10.4	−15.8	−17.0
Western Europe										
Exports	21.2	28.1	29.9	31.9	34.1	39.6	54.2	67.6	65.1	59.7
Imports	19.8	24.3	20.8	23.0	28.2	36.6	41.8	47.3	52.9	52.9
Surplus	+1.4	+3.9	+9.1	+8.9	+5.9	+2.9	+12.4	+20.3	+12.2	+6.8
Net Surplus (+) or Deficit (−)	+0.1	+2.2	+7.4	+3.5	−2.1	−8.7	+3.7	+9.9	−3.6	−10.2

SOURCE: U.S. Department of Commerce. All figures are rounded.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

U.S. Barriers to Imports

It would help to clear the air in international trade discussions if the United States were to acknowledge that all of our actions are not on the side of the angels. We have created many obstacles to inhibit imports into the United States.

Probably the most noticeable of these obstacles are the "Buy American" statutes that give preference to domestic producers in federal government procurements.[5] According to these statutes, federal agencies are required to pay up to a 6 percent differential in price for goods that are produced in the United States. In the case of military purchases, as much as a 50 percent premium is paid for domestic production. In addition, the Surface Transportation Assistance Act of 1978 requires that, for most purchases over $500,000 under the program of aid to mass transit systems, American materials and products be used. Also, American flag vessels must be used to ship at least 50 percent of the gross tonnage of all commodities financed with U.S. foreign aid funds.[6]

As shown in Table 2, many states also have "Buy American" laws. New York requires state agencies to buy American steel. New Jersey requires that all state cars be produced domestically. In addition, numerous states and municipal authorities require utilities to use American materials, whether they are investor-owned or government-owned.[7]

The Merchant Marine Act of 1936, now commonly referred to as the Jones Act, prohibits foreign ships from engaging in commerce between American ports. This law, of course, effectively bars competition in U.S. domestic marine transport. The perverse effects of such statutes are much greater than might be expected. For example, at times Canadian lumber transported by Japanese flag vessels has undersold domestic timber from Oregon in the lucrative southern California markets. In such cases, both the American merchant marine and the American timber industry suffer damage. Foreigners then become the unintended beneficiaries of these misguided attempts to subsidize the American merchant marine.

Many U.S. statutes limit imports of agricultural products such as sugar, beef, dairy produce, and mandarin oranges. Under the Meat

[5]See Murray L. Weidenbaum, *Business, Government, and the Public*, 2d ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1981), pp. 253–55.

[6]Norman S. Fieleke, "The Buy-American Policy of the United States Government," *New England Economic Review* (July/August 1969), pp. 2–6.

[7]Murray L. Weidenbaum with Michael C. Munger and Ronald J. Penoyer, *Toward a More Open Trade Policy*, Formal Publication No. 53, Center for the Study of American Business, Washington University, 1983, p. 26.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

TABLE 2

BUY-AMERICAN PRACTICES IMPOSED BY THE STATES

State	Practice
Alabama	Requires use of U.S. materials "if available at reasonable prices" in cases of public works financed by state funds.
California	Requires use of materials of U.S. origin (subject to court challenge).
Georgia	Requires state agencies to buy American products if price and quality are equal to those of foreign products.
Hawaii	Establishes a scale of preferences for domestic products.
Idaho	Requires state bids to carry a clause restricting use of foreign materials.
Indiana	Restricts use of foreign steel and aluminum.
Kentucky	Discourages state agencies from requesting foreign-made products.
Maine	Reserves the right to reject bids involving foreign products when in direct competition with American products.
Massachusetts	Grants preference, "other considerations being equal," to in-state products first and then to other American products.
New Jersey	Requires U.S. domestic materials to be used unless their cost is "unreasonable."
New York	Restricts use of foreign products through general specifications for bids.
North Carolina	Follows a policy of purchasing domestic products "wherever we deem we are not penalizing ourselves as to competition, availability, service and ultimate cost."
North Dakota	Requires certain bids to carry the phrase "bid domestically produced material only."
Oklahoma	Requires purchases of domestic goods and equipment unless a foreign product is of "equal quality" and also "substantially cheaper" or is of "substantially superior quality" and is sold at a "comparable price to domestic products."
Pennsylvania	Prevents use in state projects of foreign steel and aluminum products made in countries that "discriminate" against American products.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

TABLE 2 (cont.)

State	Practice
South Dakota	Writes state specifications for American-made products; if foreign-made is bid, award is made on condition of acceptance by the state agency.
Wyoming	Generally discourages use of foreign goods.

SOURCE: Norman S. Fieleke, "The Buy-American Policy of the United States Government," *New England Economic Review* (July/August 1969).

Import Act, the president has the authority to impose beef import quotas if imports of beef reach a certain trigger level. The United States generally has encouraged foreign exporters to restrain their sales voluntarily to avoid the imposition of formal quotas, but during the past year the administration has eliminated the pretense of voluntarism.

Although average U.S. tariff rates are low—about as low as Japan's—high tariffs are levied on some items. (See Table 3.) Tariffs on textiles average 22 percent. Duties on fruit juices are over 27 percent, and the rate on ceramic products is 14.5 percent. In addition, numerous nontariff barriers (often of a regulatory nature) are imposed by federal, state, county, and municipal governments. For example, many state and local authorities enact building codes that impose discriminatory standards favorable to local industry. The ceramic tile industry is one example. In the 1960s after Japanese imports had captured a large portion of the floor tile market in the United States, many local building codes were revised in order to screen out imported wall tile. This was brought about simply by requiring a thickness of wall tile different from that which Japan and Europe were producing.[8]

Despite this nation's overall free-trade posture, protection against imports into the United States now covers such basic industries as automobiles, steel, and textiles. Pleas for further trade restrictions extend to such esoteric sectors as mushrooms, ceramic tableware, and even mechanics' shop towels. It is not a question of merely accepting the existing array of protection. The challenge is to deal with the rising pressures for further restriction of world trade.

[8]William R. Cline, "Long-Term Changes in Foreign Trade Policy of the United States," in *The International Economy: U.S. Role in a World Market*, U.S. Congress, Joint Economic Committee (Washington, D.C.: Government Printing Office, 1980), p. 214.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

TABLE 3

MAJOR U.S. HIGH-TARIFF ITEMS, 1980
(Millions of Dollars)[a]

Product	Import Value	Duty	Average Tariff
Agricultural Products			
Dairy Products	$ 314	$ 30	9.5%
Vegetables	660	75	11.3
Beverages	2,255	153	6.8
Fruit Juices	(144)	(40)	(27.6)
Tobacco	487	60	12.2
Manufactured Products			
Wood Veneers	613	57	9.3
Textiles	8,152	1,793	22.0
Apparel	(5,500)	(1,469)	(26.7)
Benzoid Chemicals	1,444	197	13.0
Synthetic Resins	160	16	10.3
Ceramic Products	969	140	14.5
Glass Products	604	66	10.9
Specified Products	17,240	1,320	7.7
Footwear	(3,975)	(494)	(12.4)
Jewelry	(821)	(83)	(10.1)
Matches	(120)	(14)	(11.2)
Miscellaneous Products	298	38	12.7
TOTAL	$33,196	$3,944	11.9%

[a]Numbers in parentheses are selected subtotals.

SOURCE: Statistical Services Division, U.S. International Trade Commission.

The Pressures for Protectionism

The first step is to understand why protectionism is popular. Protectionism can be described as a means by which small, well-organized groups use the political process to their advantage. The benefits are received by the protected industries, while some costs are shifted to other companies who buy from the protected industries. Ultimately, most of the costs are borne by consumers in the form of higher prices.[9] Thus, protectionism can be viewed as a hidden tax on

[9]For several examples of this phenomenon, see Morris E. Morkre and David G. Tarr, *Effects of Restrictions on United States Imports: Five Case Studies and Theory*, Staff Report of the Bureau of Economics to the Federal Trade Commission (Washington, D.C.: Government Printing Office, 1980).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the consumer. A recent study at the Center for the Study of American Business at Washington University attempted to estimate that hidden tax for 1980. It came to more than $58 billion, or $255 per American consumer.[10]

Like so many sales taxes, protectionism is unfair. Another report from the Center for the Study of American Business showed that "voluntary" quotas on imports of footwear acted as a regressive tax that hurt low-income consumers more than high-income consumers.[11] These quotas, however, have been eliminated by the Reagan administration.

Protectionist measures are a two-edged sword. They may well reduce imports from abroad, but at the same time they make it more difficult for U.S. domestic firms to export their products. For example, the United States was "successful" in getting the European Common Market to restrict its exports of steel to us. But our domestic automobile industry, a major purchaser of steel, now bears the burden of higher costs, which in turn make it less competitive. All this generates pressures for more protection—witness the domestic content bill recently proposed to protect employment in the automobile industry. Lower imports also mean fewer dollars abroad to buy American exports.

From the viewpoint of economic performance, protectionist measures are counterproductive. They reduce competition. By encouraging capital and labor to stay in less-efficient industries, they also result in less productivity and lower output, especially by the domestic industries purchasing the products of the protected companies. All this generates pressures for additional protectionist measures. There are no easy answers. But we do know that trying to export unemployment via beggar-thy-neighbor policies will not work. Such actions only exacerbate economic difficulties.

U.S. Barriers to Exports

We must also acknowledge the great extent to which our government has caused self-inflicted wounds by erecting obstacles to our own exports. Frankly, that makes us a laughingstock overseas when we urge other countries to lower their barriers to our exports while we make it more difficult for our own exporters.

[10]See Murray L. Weidenbaum and Michael C. Munger, "Protection at Any Price?" *Regulation* 7 (July/August 1983): 14–18.

[11]See Jooh N. Suh, *"Voluntary" Export Restraints and Their Effects on Exporters and Consumers: The Case of Footwear Quotas*, Working Paper No. 71, Center for the Study of American Business, Washington University, 1981.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The truth is that in the United States many laws and regulations limit our exports. In many ways—and often without considering the effects—we have enacted statutes and promulgated rules that prohibit U.S. exports or make it more difficult for American companies to compete in foreign markets. For example, the Trans-Alaskan Pipeline Authorization Act prohibits the export of oil from North Slope fields. A provision added to an appropriations act for the Interior Department bans timber exports from federal lands west of the 100th meridian. When restrictions get that specific, you can detect special-interest pressures at work.

The Export Administration Act provides for controls on exports of goods and technology to protect national security. In practice, however, the law mandates controls over a great variety of products, including domestically produced crude oil, refined petroleum products, unprocessed red cedar, and horses exported by sea. In 1980 the act was employed to embargo grain exports to the Soviet Union. It was invoked again in 1981 and 1982 to carry out the ban against U.S. firms participating in the construction of the natural-gas pipeline between the USSR and Western Europe. Studies of how export controls actually work conclude that, although the great majority of applications for approval under the Export Administration Act are promptly reviewed, the more sensitive requests get tied up in a "bureaucratic morass."[12] There is also considerable evidence that the licensing system has been a powerful disincentive to exporting.[13]

Export controls do more than limit U.S. international trade for the time they are imposed. These restrictions also call into question the reliability of the United States as a supplier of products to other countries, which therefore are likely to develop alternative sources. A clear example is soybeans—hardly a product that could be considered a strategic item. Although the purpose was to contain a short-term increase in domestic prices, the main effect of the U.S. embargo of soybean exports in 1974 was to induce Japan to turn to other producing countries, particularly Brazil. Japan proceeded to invest huge amounts in that country to develop alternatives to U.S. production, thus effectively and permanently reducing our share of the world soybean market.[14]

[12]Gary K. Bertsch, "U.S. Export Controls: The 1970s and Beyond," *Journal of World Trade Law* (January/February 1981), pp. 67–82.

[13]Ibid.

[14]Statement by the Honorable C. Fred Bergsten, Assistant Secretary of the Treasury for International Affairs, before the Committee on Banking, Housing and Urban Affairs, 6 March 1979, p. 3.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The United States also conducts a great variety of domestic regulatory activities that impose costly burdens on American manufacturers. In many cases, foreign producers are not subject to similar burdens. For example, the regulations under the Federal Insecticide, Fungicide, and Rodenticide Act require exporters to notify countries for which products are destined when a hazardous product is being exported 30 days in advance of the export—even if the product is not viewed as hazardous under the laws of the importing country. The importing nation must notify the exporter that the notice was received. No other country has such a restriction.

The federal government has imposed special burdens on companies involved in foreign trade. The Foreign Corrupt Practices Act requires strict recordkeeping standards to monitor the antibribery sections of the statute. It is difficult to discuss that law without being criticized for callousness on ethical matters. However, the sad fact is that this trade statute has established a regulatory regime that displays the same cavalier attitude toward the burdens it imposes on American business as do so many other regulations.

A former chairman of the Securities and Exchange Commission, the agency administering the act, has stated, "The anxieties created by the Foreign Corrupt Practices Act—among men and women of utmost good faith—have been, in my experience, without equal." The language of the act is so sweeping and ambiguous that American firms turn down foreign business when they merely suspect that they could be charged with actions that technically might be classified as bribery.[15] In support of this claim, the General Accounting Office found, in a survey of 250 American companies, that 30 percent of the respondents engaged in foreign trade had lost business as a result of the Foreign Corrupt Practices Act.[16]

Besides the effects of trade policies, the strong foreign exchange value of the dollar makes it difficult for American companies to compete in world markets. Many factors influence the strength of a nation's currency, but our extraordinarily high real interest rates are very important. In turn, the large budget deficits are a key influence on those rates—and we cannot blame the deficits on "foreign devils." They have a made-in-America label.

An obvious solution to the deficit problem—and a major potential contributor to reducing high real interest rates—is entirely of our

[15]Cited in *Proposed Revisions of the Foreign Corrupt Practices Act* (Washington, D.C.: American Enterprise Institute, 1981), p. 10.

[16]Charles E. Bowsher, "The Government's Role in International Trade: GAO's Contribution," *GAO Review* (Summer 1982), p. 30.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

own choosing. All that must be done is to simply reduce the growth of government spending. That objective, unfortunately, is one that has not been accomplished in recent years. In real terms, federal spending is now at least as high as the projections contained in President Carter's last budget message.[17]

The United States is by no means the only nation with trade barriers. Every nation has them and they continue to grow. In 1982, Canada restricted the imports of leather goods, Austria restricted dresses, the European Community cassava, and France electronic goods. At the same time, Japan continues to find many reasons for restricting the importation of baseball bats. However, the concerns of these producers and the public will be far better served by responding to the underlying problems that generate pressures for protectionism. The answer surely is not to retaliate and thus open the way for a return to the trade wars of the 1930s which exacerbated the great depression.

Positive Approaches to Trade Policy

Five positive steps toward trade liberalization can be outlined. First and foremost, we need to implement domestic economic policies that expand production and incomes while holding down inflation. This, of course, is a plea for tax simplification, government spending restraint, and regulatory relief. A healthy economy nips the protectionist sentiment in the bud.

Second, we need to maintain greater balance in macroeconomic policies. The shift in the United States in 1981 to tight monetary policy and expansive fiscal policy contributed substantially to high interest rates and a rise in the value of the dollar. If we are not careful, we will see an easy money policy—coupled with large budget deficits—lead to another inflationary spiral, which would further reduce the competitiveness of U.S. products in world markets.

Third, we need to limit government "trade adjustment assistance"—which seems to be a politically necessary part of any comprehensive trade policy—to temporary aid in shifting labor and capital from industries hard hit by imports to more competitive activities. All too often, government aid merely maintains an inefficient and uncompetitive industrial structure. In turn, this inefficiency adversely affects our competitiveness in world markets and generates further pressure for additional protectionist measures. The result is lower

[17]Murray L. Weidenbaum, *Dealing With Deficits and the Rise in Federal Spending*, Contemporary Issues Series, Vol. 3, Center for the Study of American Business, Washington University, 1982, pp. 4–5.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

domestic employment that generates additional pressures for government interference. This cycle represents a more general principle: Government intervention begets more government intervention.

A healthy, dynamic economy is a flexible economy. It is an economy where business executives, consumers, and workers have continuing opportunities to invest their capital, tailor their spending, and find employment in response to market forces. This process should not be retarded by artificial government barriers or props.

In a healthy and dynamic economy we must expect that some industries and regions will grow more rapidly than others and that some sectors will experience difficulty in maintaining their position and may even decline. We must avoid the economic inefficiency and waste that occur when sectors experiencing difficulty seek government aid, while healthy sectors focus on more conventional business matters. When the forces of competition are strengthened and broadened, the prospects for productivity growth are enhanced and domestic industries experience improved competitiveness in world markets. Conversely, when companies get in the habit of looking to the government for help, their own entrepreneurial and risk-taking characteristics are weakened.

We delude ourselves if we think that the solution to the real problems facing American industry is more government intervention. Federal aid does not come without strings attached. Any business executive who still believes that government is his friend is too naive to be allowed out alone at night.

Fourth, we need to acknowledge the positive role of multinational corporations in the world economy. Multinationals adapt to change more readily and are less likely to plead for protection than other companies.[18] They are also the private-sector alternative to foreign aid and other types of government intervention to encourage the growth of developing nations. This, of course, explains why so-called transnational enterprises are being attacked in international organizations and are increasingly subject to regulation by the United Nations.

Fifth, we need to focus more on improving our own productivity. We cannot blame our poor production practices on foreigners. The answer is not to prop up domestic industries via import restrictions or government subsidies—or to play King Canute and try to prevent them by law from closing down or "running away." Rather, labor and management in each company need to face the challenge of greater productivity and enhanced competitiveness. Management must show

[18]Ingo Walter and Kent A. Jones, "The Battle Over Protectionism: How Industry Adjusts to Competitive Shocks," *Journal of Business Strategy* (1982), pp. 37–46.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the way. Cutting back on the proliferation of staff activities and layers of executives creates an operating environment in which labor is more likely to accept changes in factory work rules that are unnecessarily costly, and in which wage rates and fringe benefits can be brought back to reality. We must acknowledge the painful fact that foreign competition is the most effective spur to greater productivity. The sun is not going to set on U.S. manufacturing companies. In fact, it will rise on those that make the hard decisions that bring productivity up and costs down.

The current economic problems that face the United States and many other countries will not be solved by responding to the parochial concerns of steel producers, citrus growers, and automobile makers. Nor should international economic relations be dominated by short-term protectionist pressures from the producers of edible seaweeds, casein, and manhole covers (to name some recent candidates for protection).

Economies such as ours, which have become more service-oriented, need to overcome the historic preoccupation with commodity trade. As can be seen in Table 4, the United States has run a substantial deficit in its trade balance in goods over the past decade. Yet, what is less widely appreciated is that over the same period, this nation has experienced a positive trade balance in goods and services combined. In order to develop trade policies that accord with current realities, we need to focus on the total flows of commerce among nations. That includes services as well as goods, and investments as well as current account transactions. After all, it is from the totality of our economic dealings with other economies that we gain the totality of benefits from a more open exchange of things—and ideas.

The Case for Free Trade

We must focus once again on economic fundamentals. In the immortal words of Adam Smith:

> It is the maxim of every prudent . . . family, never to attempt to make at home what it will cost . . . more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker. . . . What is prudence in the conduct of every private family, can scarcely be folly in that of a great kingdom.[19]

[19]Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, Modern Library ed. (New York: Random House, 1937), p. 424.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

TABLE 4

COMPARISON OF U.S. TRADE BALANCE IN GOODS AND SERVICES
(Billions of Dollars)

Category	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Goods										
Exports	74.0	101.7	111.1	120.2	128.2	150.0	191.0	232.4	246.7	223.3
Imports	75.1	108.8	103.0	129.1	157.7	183.4	220.3	260.2	276.2	259.5
Excess of Exports (+)	−1.2	−7.2	+8.2	−8.9	−29.6	−33.3	−29.3	−27.8	−29.4	−36.2
Services										
Exports	36.3	45.0	44.6	51.4	56.1	70.0	95.8	109.7	127.9	125.0
Imports	24.1	28.7	30.0	33.3	36.4	47.0	61.8	74.3	86.9	92.0
Excess of Exports (+)	+12.2	+16.3	+14.6	+18.1	+19.7	+23.0	+34.0	+35.3	+40.9	+33.0
Net Surplus (+) or Deficit (−)	+11.0	+9.1	+22.7	+9.2	−9.9	−10.3	+4.7	+7.5	+11.5	−3.2

SOURCE: U.S. Department of Commerce. All figures are rounded.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The arguments in favor of free trade are supported by a great deal of historical evidence.[20] During the 1930s, however, the United States and many other countries followed "beggar-thy-neighbor" trade policies which contributed to the worldwide depression. The Smoot-Hawley protectionist tariff epitomized this approach in the United States. (Unfortunately, memories are short. Some of our young people think that Smoot-Hawley is a British rock group.)

Subsequently, our trade policy shifted to the negotiation of reciprocal trade agreements. These tariff reductions were followed by an acceleration in world trade and economic growth. That was not just coincidence. The United States had similar positive experiences with open trade in the 19th century.

Let us recapitulate the benefits of freer trade:[21]

- Open trade contributes to lowering inflationary pressures by increasing the supply of goods and services competing for the consumer's dollar. Thus, the question of free trade is basically a consumer issue.
- Open trade minimizes the role of government in influencing private-sector decisions, thus allowing individuals and business firms to respond to the needs and pressures of the international marketplace. Free trade is fundamental in promoting economic freedom and the private-enterprise system.
- Open trade improves the efficiency with which our own resources are allocated. It thereby yields more growth, higher levels of employment, and an improved standard of living at home.

International trade policy will not remain static. The choice now facing the major trading nations is between a further drift to protectionism or a joint effort to remove trade barriers. Surely the credibility of this country's commitment to open and freer trade is not enhanced by companies sending their lawyers to Washington on Monday to seek the removal of import barriers overseas, and then turning around on Wednesday to send the same attorneys back to Washington to advocate import restrictions on the products of their foreign competitors. Free trade is a two-way street.

As in so many other aspects of economic policy, time is an important but often neglected factor. The longer we wait to move decisively to freer world trade, the more obstacles will be in place and the more difficult it will be to remove them. The best time to move to free trade is now.

[20]See Robert R. Russel, *A History of the American Economic System* (New York: Appleton-Century-Crofts, 1964), chaps. 25 and 38.

[21]For a more detailed analysis of trade effects, see Herbert G. Grubel, *International Economics* (Homewood, Ill.: Richard D. Irwin, 1977).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

CONSTITUTIONAL REFORM: A PREREQUISITE FOR SUPPLY-SIDE ECONOMICS

Dwight R. Lee

A Political Post-Mortem on Supply-Side Economics

We no longer hear much about supply-side economics. Its strongest proponents have left the Reagan administration and those who remain appear to have little commitment to promoting its theories. It is easy to get the impression that supply-side economics was little more than a fad that emerged from the rhetoric of the 1980 presidential campaign and has since been discredited by experience.

But supply-side economics is not a fad. It is solidly grounded in a body of theoretical economics that has been developing for over 200 years.[1] Neither has supply-side economics been discredited by experience. The history of the United States provides compelling testimony to its effectiveness. The recent so-called failure of supply-side economics has been political, not economic. The post-mortem that this economic theory faces is being performed by a political process that can no longer focus beyond short-run concerns. Genuine supply-side policy is necessarily a long-run policy, and it is quickly rendered impotent by the policy reversals and uncertainties that characterize a political process that responds primarily to immediate, short-run imperatives. The historical success of supply-side economics will remain just that, history, unless we are able to reinstate genuine limits on the myopic motivations of political decision makers. It will be only with constitutional reform limiting political discretion that

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Associate Professor of Economics at George Mason University and a Research Fellow at the Center for Study of Public Choice, Fairfax, Va, 22030.

[1]See David G. Raboy, "The Theoretical Heritage of Supply Side Economics," in *Essays in Supply Side Economics*, ed. David G. Raboy (Washington, D.C.: Institute for Research on the Economics of Taxation, 1982).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

supply-side policy will once again become the foundation for renewed economic growth and vitality.

Supply-Side versus Demand-Side

Stripped to basics, supply-side economics is simply a restatement of one of the most fundamental economic principles: Increase the relative return to engaging in an activity and there will be an increase in that activity. Of particular relevance to supply-side economics is the return to leisure and consumption relative to the return to production and investment. If the relative return to leisure and consumption is increased, people will produce less and attempt to consume more, which can be successful only in the short run. But if the relative return to productive activities is increased, people will substitute productive pursuits for consumption, which will lead to more consumption in the long run.

All governmental activities, whether spending money or raising taxes, have some effect on the relative return to different activities. For example, by reducing the cost of being unemployed, unemployment compensation increases the unemployment rate. Although concerned with all public policy and its effect on incentives, supply-side economics has concentrated primarily on the impact of taxation. To a supply-side economist, the importance of a change in taxes is in the resulting change in relative returns. The advantage in reducing the marginal tax rate on interest income is the increased incentive to save, which increases the potential for investment and long-run economic growth. There are similar advantages in reducing the marginal tax rate on income (the return to labor) and capital gains (the return to investment). In each case, the tax reduction may immediately increase take-home income and motivate taxpayers to spend more.[2] This short-run effect, however, is not the one that is of most interest to supply-side economists; they are more interested in focusing on productivity increases that necessarily require a long interval of time before they are fully realized.

Keynesian economics, which has dominated the macroeconomic policy perspective for decades, has also been concerned with the effects of governmental spending and taxing policy. From the

[2]It should be noted that a marginal tax rate can be reduced without lowering the average tax rate, so a marginal tax rate reduction may have no effect on spendable income. Also, even if a tax cut reduces total tax payments, it does not follow that there will be a positive income effect (an increase in real income) once the value of publicly provided services are taken into consideration. See James D. Gwartney and Richard Stroup, "Labor Supply and Tax Rates: A Correction of the Record," *American Economic Review* (June 1983): 446–51.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Keynesian view, however, the pivotal feature of governmental policy comes from its influence on the demand side of the economy. Keynesians focus on the gap between potential GNP (the value of output the economy is capable of producing) and actual GNP (the value of output actually being produced). When this gap is positive, the problem is seen as one of inadequate demand and the Keynesian response is for government to cut taxes or increase spending or both in order to increase the current rate of spending. Through a multiplier effect, Keynesians hold that a relatively small initial increase in spending can stimulate a large increase in demand and restore a depressed economy to its full productive potential. If demand exceeds the full employment potential of the economy, however, inflation will result; and the appropriate response is to combine tax increases and spending cuts to reduce demand.

The objective of Keynesian economic policy is to fine-tune aggregate demand in order to stabilize the economy and keep actual GNP as close as possible to potential GNP. The Keynesian orientation is relatively short run, emphasizing the near-term consequences of changes in spending and taxing decisions. Keynesians have paid little attention to the long-run effect of these decisions on the productive capacity of the economy. In contrast, supply-side economists emphasize that the real economic problem is pushing back the limits on our ability to produce, not encouraging consumption. There will be short-run fluctuations in demand, but over the long run if there is an increase in the goods and services produced, demand will keep pace. Unfortunately, increasing productive capacity requires sacrifice, effort, and time and, unlike demand-side policy, can do little to pump up the economy before the next election.

Politics and Patience

In evaluating economic policy it is important to recognize that democratic political processes are inherently myopic. The success of economic policy depends at least as much on political incentives as it does on economic incentives. The success of Keynesian economics, for example, was primarily political and had less to do with its theoretical soundness than with its tendency to cater to the shortsighted proclivities of the political process.[3]

[3]On the other hand, even if Keynesian economic theory had been completely sound, its success as economic policy would have been undermined precisely because it provided a rationale for politicians to do what they wanted to do all along: concentrate on short-run objectives. See James M. Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

It is impossible to erradicate political myopia in a democratic political order. Some short-run political expediency is simply part of the price to be paid for the benefits that political democracy offers. But achieving the ideals of democracy does not depend on any particular institutional arrangement, and some arrangements can be expected to perform better than others.[4] Before returning to the challenge that political myopia poses for supply-side economic policy and considering possibilities for meeting it, a discussion of why political decision makers tend to concentrate on the near term and ignore the long term will be useful.

As individuals, politicians are much the same as anyone else. They are not inherently shortsighted and will take a long-run perspective if it is to their advantage to do so; otherwise, they will concentrate on the more immediate effects of their decisions. Politicians tend to be shortsighted because of the political incentive structure within which they operate. The most obvious inducement for politicians to focus on short-run consequences is provided by the desire to survive periodic elections. When considering alternative policy proposals, then, there is a tendency to exaggerate the importance of those results that will occur before the next election and to put less weight on post-election consequences. The politician whose policy recommendations provide long-run benefits far in excess of the costs is unlikely to receive credit if he is defeated at the polls because the cost was evident. On the other hand, a policy that provides immediate benefits will be attractive to a politician facing an election, even if the long-run costs (which may be hard to trace to the policies and politicians responsible) are far greater than the benefits.

It is not difficult to find examples that strongly suggest political sensitivity to pre-election outcomes. From 1950 (when the first major increase in social security benefits was legislated) through 1974 (after which cost-of-living adjustments have automatically increased social security benefits), the U.S. Congress increased social security benefits eleven times; eight during election years. Furthermore, in seven of the eight cases, the increase in social security taxes needed to pay for the augmented benefits was postponed until after the election. After social security payments, veterans' benefits make up the largest component of governmental transfers; and the most likely time to observe a surge in these benefits is shortly before elections. According to Edward Tufte, "Since 1962, Veteran benefits have increased

[4]For an elaboration of this point, see Friedrich A. Hayek, *Law, Legislation, and Liberty*, vol. 3: *The Political Order of a Free People* (Chicago: University of Chicago Press, 1979).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

an average of $660 million (at annual rates) between the third and fourth quarters of election years, but only $220 million in years without elections."[5]

Recurring elections would not provide much explanation for myopic political decisions if voters were motivated to be informed and held their elected representatives accountable for the long-run consequences of their decisions. Giving voters the power to vote politicians in or out of office is based on the hope that politicians will respond to public concerns—concerns that surely include long-run considerations. But individuals have little motivation to acquire the information necessary to determine before the fact, or recognize after the fact, the long-term consequences of political decisions.

Informed and farsighted political decisions provide general benefits that are available to individuals whether or not they are informed and involved. In other words, being informed on broad political issues gives voters no more claim on the advantages of good public policy than is available to the uninformed.[6] It is quite rational, then, for people to remain politically ignorant and concentrate on being informed in areas where additional knowledge provides differential advantages.[7] Our well-being is surely influenced more by political decisions on major economic policy than by our choice of shoes. Yet, most people will be more informed on shoe fashions than they will be on the intricacies of economic policy.

Of course, the immediate consequences of a policy can often be associated with that policy without having detailed information or knowledge. But even the most informed citizen will generally find it difficult to anticipate the long-run effects of a policy or make the connection between effects and the policy responsible for them. The politician is fully aware of this problem and recognizes that he is much more likely to be held accountable for the near-term results of his decisions than for the long-term results, and he focuses his time perspective accordingly.

A pertinent example is the political popularity of inflationary policies. Expanding the money supply allows politicians to provide

[5]This example, along with the social security example, is documented in Edward R. Tufte, *Political Control of the Economy* (Princeton, N.J.: Princeton University Press, 1978), chap. 2.

[6]It is useful to think of sound public policy decisions as public goods. See Gordon Tullock, "Public Decisions as Public Goods," *Journal of Political Economy* 79 (July/August 1971): 913–18.

[7]This is not to deny that many people realize personal satisfaction simply from being informed on a broad range of political issues, but for most people it takes little knowledge to satiate their desire for political knowledge.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

highly visible and immediate benefits that they can easily take credit for. Public projects can be financed, services can be provided, subsidies can be given, interest rates can be temporarily reduced, and employment can be temporarily increased by simply expanding the money supply. It is only after some lag that these benefits are paid for through higher inflation, a cost that is spread over the entire population. Politicians have been remarkably successful at shifting blame by convincing the public that inflation is the fault of labor unions, business profits, bad harvests, OPEC, or irresponsible consumer spending.

Another approach to explaining political myopia concerns a bias in political communication. It is easier for relatively small groups with narrowly focused concerns to organize and communicate their demands through the political process than it is for large groups with diverse concerns. This bias has allowed single-issue groups to use the political process to capture benefits at the expense of the general public. The result is a pattern of governmental expenditure and involvement that would probably not be chosen by anyone if judged as a complete package. Each special interest would likely see an advantage in moderating and deferring its political demands if similar moderation and patience would be exercised by all other interest groups. Unfortunately, since it is hard to arrange for well-defined private property rights in politically controlled resources, the information and incentives that come from market exchange are absent.[8] In the political process, individuals are unable to communicate their preferences in ways that encourage honesty and reciprocity.

When politically influential groups are able to exploit the political process for immediate gain, they realize that restraint will give them no preferential claim on future benefits in exchange. The "political capital" that would be generated by responsible fiscal decisions cannot be marketed because it is not private property. The politician who exercises the restraint necessary to maximize the long-run value of his contribution cannot realize this value at the end of his political career by selling his political capital. Similarly, constituents who contribute to the value of "political capital" by moderating their demands cannot benefit from their contribution.

[8]Politically controlled resources are usefully characterized as common property resources with control determined by the rule of capture. The problems that arise when resources are commonly owned are discussed by Garrett Hardin, "The Tragedy of the Commons," *Science* 162 (1968): 1243–48. For a discussion that deals specifically with the problem of politically controlled resources as common property, see John Baden and Rodney D. Fort, "Natural Resources and Bureaucratic Predators," *Policy Review* (Winter 1980): pp. 69–81.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Politicians, and the special interest groups that support them, are in much the same position as the American buffalo hunters in the 1870s. Each hunter knew that all hunters would be better off in the long run if everyone reduced the slaughter of the buffalo. In the absence of private ownership, however, each also knew that the buffalo he spared today would be shot by someone else tomorrow. Individual hunters found that there was little to gain but much to lose by taking a long-run perspective and exercising restraint.[9] Political decision makers also find that there is little to gain but much to lose if they neglect short-run demands on the economy, even though in the long run those demands will exterminate much of our productive capacity.

The Destructive Tax Trap

Given the shortsighted proclivities of unrestrained political action, it is possible to understand the obstacles to a genuine supply-side economic policy. In order to appreciate fully the political dilemma facing the supply-side approach, we must examine the shortsighted dynamics that have given us the destructive tax burdens that supply-side economists hope to alleviate. We find that it is extremely difficult to reduce destructive tax burdens even when they are widely recognized as such.

To make a convincing argument that the democratic process tends toward excessive tax burdens, a criterion for judging the appropriateness of the tax burden must be established. The criterion is conceptually straightforward, though difficult to apply in practice. Increasing taxes generates costs and benefits. When taxes are increased, the costs are measured by the value of the private production that is sacrificed, and the benefits are measured by the value placed on the public services that can be provided. Ideally, taxes should be increased until the value of the additional private productivity sacrificed is equal to the value of the additional public services provided. While it is difficult to know exactly at what point this balance is reached, some things can be said about the range within which the ideal tax burden is found. It is helpful to look at the tax rate–tax revenue relationship, popularly known as the Laffer curve.

Although there are many different taxes and tax rates, little harm is done at the conceptual level by talking as if there is but one relevant rate. The Laffer curve depicts the long-run relationship between this

[9]For many interesting details of the buffalo slaughter, see John Hanner, "Government Response to the Buffalo Hide Trade," *Journal of Law and Economics* 24 (October 1981): 239–71.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

tax rate and the tax revenue that is raised. A representative Laffer curve is shown in Figure 1, where the tax rate is measured on the vertical axis and tax revenue is measured on the horizontal axis. Although the Laffer curve is the object of some controversy, its basic logic is obvious and unassailable.

If a tax rate of zero is applied to the tax base, it is clear that no tax revenue will be raised; therefore, the Laffer curve starts at the origin, or intersection, of the axes. If the tax rate is increased above zero, tax revenue will become positive. Over some initial range of tax rates, there are two reasons why increasing the tax rate will increase tax revenue. First, increasing the percentage of a given base that is taken through taxation increases tax revenue. Second, up to some point the tax revenue allows government to better protect private property rights and provide important public goods, which creates a favorable environment for productive economic activity and thus generates an expansion in the tax base.

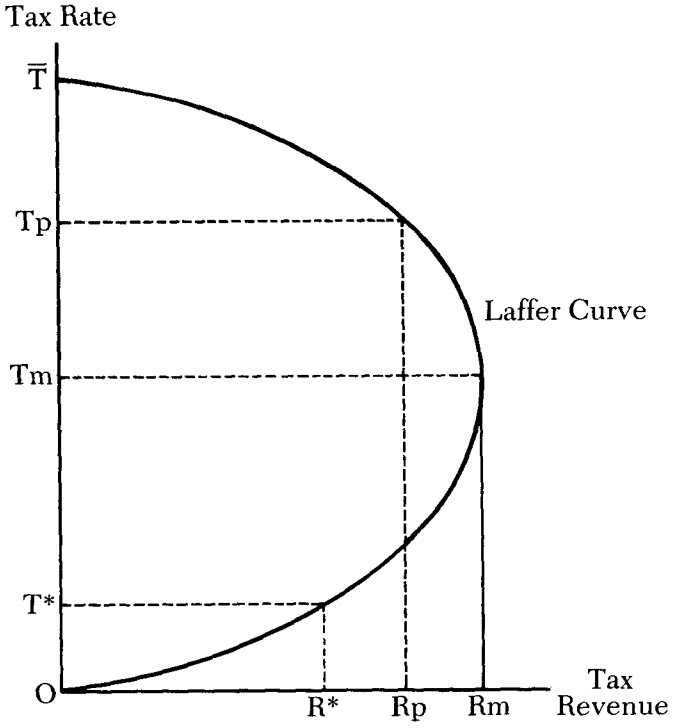


Figure 1
LAFFER CURVE

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

At some point, the disincentives to productive activity caused by an increase in the tax rate more than offset any positive effects from governmental activity, and the higher tax rate causes a reduction in the tax base.[10] Tax revenue will continue to increase with an increasing tax rate, however, as long as the percentage reduction in the tax base is not as large as the percentage increase in the tax rate. But there is a point where the tax base will decline enough in response to a higher rate so that increasing the rate will have no effect on tax revenue. This point occurs when the tax rate reaches T_m and tax revenue equals R_m in Figure 1. It is at this point that the government maximizes the revenue it receives from taxes. If the tax rate is increased above T_m, revenue will actually decline as the reduction in the tax base more than offsets the effect of the higher tax rate. At some sufficiently high tax rate, shown as $\overline{T}$ in Figure 1, tax revenue will fall to zero, since the tax burden has destroyed all incentive to remain productive, except possibly in the underground economy. No one knows exactly how high $\overline{T}$ is, but there can be no doubt that such a tax rate exists.

The controversy over the Laffer curve does not concern the existence of the rate-revenue relationship, but the question of where we are on it. Some enthusiastic supply-siders, sometimes known as Lafferites, have argued that we are on the upper half of the Laffer curve, with the effective tax rate exceeding T_m. In this view, a reduction in the tax rate would motivate such a large increase in productive activity that tax revenue would increase. Others have argued that taxes have not reached such destructive levels and that we are still on the lower half of the curve. Much of the popular discussion on supply-side economics has centered on this controversy and has left the impression that the case for supply-side economics depends on tax rates having been increased beyond revenue-maximizing limits. This is not the case. Supply-side economics claims that the tax burden has become *excessive* and that tax rates have increased beyond the point where the value the government can provide by an additional increase in taxes is equal to the resulting sacrifice in private production.

[10]The reduction in the tax base will occur both because some production will not take place at the higher tax rate than would have taken place at a lower rate and also because some production will be hidden from the tax authorities; that is, it will go underground. Although underground production is better than no production at all, such economic activity is generally less productive than if it were performed aboveground because of the resources and effort devoted to avoiding detection. For a discussion of the literature on the underground economy, see Carl P. Simon and Ann D. Witte, "The Underground Economy: Estimate of Size, Structure and Trends," *Special Study on Economic Change*, Vol. 5: *Government Regulation: Achieving Social and Economic Balance* (Washington, D.C.: Government Printing Office, 1980), pp. 70–120.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

While we may never be able to pinpoint the ideal tax burden, we know that the ideal tax rate is reached well below the point where tax revenue is maximized; that is, tax rate T_m in Figure 1. Figure 1 demonstrates that the government gains no additional revenue with which to expand services if there is a marginal tax rate increase at T_m. On the other hand, this increase will reduce private sector productivity. Obviously, one does not want to increase the tax rate to the point where no benefits are received in return for the additional costs incurred. Tax rate T_m is excessive. The ideal tax burden is imposed at a tax rate, such as T*, on the lower portion of the Laffer curve.[11] There are strong reasons for believing, however, that the democratic process exerts constant pressure toward excessive tax burdens, It is quite possible for politicians, responding to the incentives of ordinary politics, to actually increase the tax burden to the destructive levels represented on the top half of the Laffer curve.

Politicians obviously place a positive value on additional tax revenue. The more tax revenue available, the easier it is for politicians to satisfy the so-called urgent demands placed on them by politically influential interest groups. Of course, special interest groups do not have a free hand when it comes to acquiring governmental favors, since politicians are not insensitive to the political costs associated with raising taxes. But tax increases are spread widely over a politically unorganized public and can be made to appear largely independent of political decisions (e.g., inflation-induced bracket creep), while tax proceeds can be directed rather precisely to those coalitions and constituencies that have the greatest political influence. Therefore, the political costs of tax increases will be heavily discounted relative to the political gains from the additional tax revenue. This bias alone exerts tremendous pressure for an excessive tax burden. In an ideal world, the political benefit-cost ratio would mirror the social benefit-cost ratio, and politicians could only gain from raising taxes when the social benefits from doing so exceeded the social costs. Given the opportunities for maximizing political gains by concentrating benefits while minimizing political losses by spreading costs, however, the political benefit-cost ratio is distorted in favor of taxing and spending.

The tendency toward excessive tax burdens is accentuated by political myopia that causes politicians to see tax rate increases as more

[11]Somewhat surprisingly, some Lafferites have argued that the appropriate tax rate maximizes tax revenues. According to Jude Wanniski, for example, "This [the revenue-maximizing rate] is the rate at which the electorate desires to be taxed." See Jude Wanniski, "Taxes, Revenues, and the Laffer Curve," *The Public Interest* (Winter 1978), pp. 3–16.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

potent sources of revenue than they really are. It must be recognized that there are long lags between the time a change in the tax rate occurs and the time when the effect of the change is fully realized. The existing stock of capital, whether physical or human, does not immediately diminish when the tax on the return generated is increased. Decisions to replace and expand these capital assets will be discouraged, but the productivity of those already in existence will depreciate only through time. Similarly, a tax cut will encourage decisions to expand investment, but the resulting increase in productivity and the tax base cannot be fully achieved immediately. Realizing the full impact of a tax cut requires time for investments in physical and human capital to be planned and implemented and to facilitate the production of new wealth.

These lagged fiscal effects produce a temporal asymmetry between increasing taxes and reducing them. Increasing tax rates will increase tax revenues more in the politically relevant short run than in the eventually relevant long run. Turning this coin over, a tax rate decrease will decrease tax revenues more in the short run than in the long run. The political bias this creates in favor of tax increases is obvious. Although much of the revenue gain derived from increasing taxes is temporary, it is temporary gains that fuel the political process. Tax increases that are obviously too high even from the politician's perspective, once their long-term consequences have been entirely realized, will still be enticing to myopic politicians. And even when long-run effects are realized, those politicians who inherit the unfortunate legacy of high taxes will have little incentive to reduce them. Even if a tax reduction would increase revenue in the long run, it could result in a significant revenue decrease in the short run, a consideration that would be politically controlling.

The Lafferites, in their enthusiasm for immediate benefits to be realized from a tax cut, have ignored the importance of the short-run/long-run distinction in the consequences of taxation. Ironically, it is this distinction that provides the theoretical support for their central claim—that reducing tax rates will increase tax revenues. If the impact of tax changes were as immediate as some Lafferites seem to indicate, it would be extremely difficult to argue that any government would increase taxes to the point of actually reducing revenues. If the government operated benevolently, concerned only with promoting the public interest, it would certainly not increase tax rates to the point of reducing tax revenues. To do so would impose an unnecessary cost on private production and reduce the government's ability to provide useful goods and services. At the other extreme, if the government operated as a revenue-maximizing Leviathan, con-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

cerned only with promoting the narrow interests of those with political power, it still would find no advantage in increasing tax rates above revenue-maximizing limits.

What makes no sense in the absence of fiscal lags, however, may be quite understandable once those lags are considered. The possibility that tax rates will be increased to a level that actually reduces revenues becomes plausible once the time dimension of fiscal impacts is recognized. Politicians, tempted by the transitional revenue gains from successive tax increases, may well continue to push tax rates up even when the long-run effect is to reduce revenues.[12] It seems quite likely that this is exactly what has happened in the United States and other western democratic countries. Effective tax rates have increased steadily, commonly with the help of inflation, even though the long-run consequence has surely been to impede economic productivity and possibly reduce tax revenues below what they would have been under more modest tax burdens.

Although economically destructive tax burdens may not have reached the point of reducing tax revenues, this possibility cannot be dismissed out of hand. The dynamics of short-run political expediency are capable of driving tax rates up to the point where cutting marginal tax rates would actually generate a long-run increase in tax revenue. Whether or not tax rates have ben increased into the upper half of the Laffer curve, there can be no reasonable doubt that the myopia of ordinary politics has imposed an excessive tax burden on the economy. Who can believe that the long-run gains in productivity that would be motivated by a permanent reduction in the tax burden would not exceed the long-run losses that might result from underfunding governmental programs?

In the case of the tax burden, how we got to where we are has important implications for the prospects of improvement. In travelling the shortsighted political path to excessive tax rates, expectations have been formed that will make it very difficult to reduce taxes. The reason goes beyond the obvious point that short-run revenue loss from reducing taxes will, in the minds of shortsighted politicians,

[12]This has been explored in James M. Buchanan and Dwight R. Lee, "Politics, Time, and the Laffer Curve," *Journal of Political Economy* 90 (August 1982): 816–19; and in *idem*, "Tax Rates and Tax Revenues in Political Equilibrium: Some Simple Analytics," *Economic Inquiry* 20 (July 1982): 344–54. In the first paper it is shown, assuming political myopia, that a strictly revenue-maximizing government will always move toward a political equilibrium where the tax rate is above that which maximizes long-run revenue. In the second paper, the objective of government is to maximize a generalized utility function in which tax revenue enters as a good and the tax rate enters as a bad. Staying with the assumption of political myopia, it is shown that political equilibrium may still call for a tax rate above the long-run, revenue-maximizing level.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

outweigh the long-run economic benefits. Even genuinely farsighted politicians will find it difficult to reduce taxes once they have reached excessive levels.

The public has increasingly become aware that taxes are at destructive levels because of the short-run incentives that guide political decisions. As long as the public realizes that there has been no permanent restructuring of political incentives or no additional restraints imposed on the politician's ability to respond to short-run pressures, it quite rationally expects that any tax cut will be temporary. Investors will see an immediate, full-investment response to a tax cut as locking their wealth into a position that makes it vulnerable to the next tax increase.[13] The supply-side stimulus provided by a tax cut, which takes a long time under even the most favorable circumstances, takes even longer in the expectational environment created by a history of shortsighted governmental policy.

In this setting, even if a political administration wanted to take a long-run perspective, it would have difficulty implementing a permanent tax cut. There would be a reluctance to respond quickly and fully to tax cuts put into effect, even if investors had complete confidence in that administration. Given the short-run incentives facing politicians, the farsighted actions of such an administration would be seen as anomalies that would soon be reversed by politicians with more conventional time horizons. This investor reluctance would serve to undermine the resolve of the most resolute political tax-cutters. The delayed and timid supply-side response to tax cuts would create temporary shortfalls in tax revenues and activate strong political pressure against maintaining the cuts.

The 1981 Reagan tax cuts provide an example of the problem. In the case of income taxes, the Reagan cuts really were not cuts at all. They amounted to nothing more than a partial offset to inflationary bracket creep and increases in Social Security taxes.[14] Despite this, even before they went into effect, politicians in both political parties expressed concern that the Reagan "cuts" were not working, and there was significant political pressure to reverse the cuts. As a result,

[13]An example of the fickle nature of tax cuts that are supposedly motivated by the desire to prompt long-run commitments of investment funds is seen in the congresssional repeal, within a year of its enactment, of the law permitting companies to buy and sell tax benefits that arise from depreciation on capital investment. For a discussion, see "Uncertainty Cripples Tax Leasing as Law Makers Consider Change," *Wall Street Journal*, 5 April 1982, p. 25.

[14]See Steven A. Meyer and Robert J. Rossana, "Did the Tax Cut Really Cut Taxes?" Federal Reserve Bank of Philadelphia *Business Review* (November/December 1981), pp. 3–12.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

in 1982 Reagan backed away from his pledge not to raise taxes and supported a successful move to offset the 1981 tax "reductions" with tax increases, euphemistically referred to as revenue-enhancing measures. Obviously these political pressures and reversals do little to generate the investor confidence needed for a genuine supply-side response to tax cuts.

Even if tax rates do reach the destructive levels represented by the upper half of the Laffer curve, it will be extremely difficult to reduce them. The transitional gains that activate the political process can lead us into a destructive tax trap and the hopes of supply-side economists can be frustrated. A supply-side response to tax cuts will not be quickly forthcoming unless the cuts are known to be permanent, and tax cuts will not be permanent unless they motivate a prompt supply-side response.

Constitutional Reform and the Resuscitation of Supply-Side Economics

Given the current political environment, genuine supply-side economic policy is effectively dead. Supply-side economic policy will never be given a real opportunity until politicians give serious consideration to the long-run consequences of their decisions. Yet, unless real constraints are imposed on the ability of politicians to respond to special interest demands, political decision making will continue to be dominated by short-run considerations. There is really no basis for blaming the politicians. Given the situation in which they find themselves, their behavior is perfectly predictable. As long as the only criterion for determining the legitimacy of a governmental action is the approval it receives from politically influential coalitions, politicians will be compelled to focus on short-run expediencies.

When unrestrained political power makes politicians the lackeys for organized special interests and special interests become the victims of the productivity-destroying excesses of their own short-run demands, there is the potential for all to benefit by accepting some self-denying limits on government. If politicians could honestly say to politically organized groups, "My hands are tied; I cannot provide more benefits to special interest groups by imposing additional costs on the public at large," then the scope for shortsighted political exploitation of one group by another would be reduced. A government that can credibly tell people that there are *clear limits* on how much of their productive efforts can be taken from them will be in a better position to encourage productive investment than will a government that cannot commit itself to such limits. The best and maybe

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the only hope for motivating a move away from parasitic transfer activities and toward productive, wealth-creating activities that will, in the long run, make everyone better off, is having constitutional limits on the scope of government.

The destructive tax trap discussed in the previous section provides a good example of the need for constitutional limits. Once the tax burden has reached destructive levels, there is little hope that permanent tax cuts can be achieved through the workings of ordinary politics. Even if the long-run effect of a tax cut would motivate an expansion in investment and productivity sufficient to actually increase tax revenues, politicians will be reluctant to cut taxes if the short-term effect is to reduce revenues. Because investors have learned to view the political process as shortsighted, they will be reluctant to make productive, long-term investments in response to any tax cut. This is a self-fulfilling expectation, as investors' reluctance to respond to a tax cut in ways that expand the tax base makes it extremely difficult politically to maintain such a cut. Without some resolution of this dilemma, everyone is worse off in the long run: Government has less revenue than it could have, and the private sector suffers from a higher tax burden and lower productivity than it needs to.

Escape from the destructive tax trap and a political resuscitation of supply-side economics require that government convince the public that it is not only cutting taxes, but cutting them *permanently*. This means convincing the public that current politicians will persist with a tax cut and, further, that the cut will not be rescinded in the future. It is here that the advantage of constitutional limits on the fiscal powers of government can be seen. Constitutional limits are a means to reach forward in time and control the behavior of future decision makers in a way that allows current decision makers to behave more responsibly. Consitutional restrictions that prevent future politicians from gaining short-run advantages by increasing taxes creates a setting in which current politicians can look beyond short-run concerns and focus on the long-run advantages of lower taxes. Durable limits on the ability of politicians to cater to the demands of organized interests by increasing the tax burden are essential if the political process is to lengthen its vision and provide supply-side economic policy a real opportunity to revitalize economic productivity.

The Prerequisite of Constitutional Change

In the 18th century the French political philosopher Montesquieu asked: "Will the state begin by impoverishing the subjects to enrich itself? Or will it wait for the subjects to enrich it by their own

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

prosperity?"[15] In most countries during most of human history, Montesquieu's first question has received an affirmative answer. In the United States we have been fortunate in that our government has, until recent decades, been restrained against enriching itself by exploiting the productivity of its citizens. The result was years of savings, investment, and productive effort that created a prosperous population and a prosperous government as well.

In the broad sense, the founding fathers were supply-siders. They were not interested in governmental policy designed to maintain strong demand. Indeed, if such a policy had been suggested it would have been considered rather bizarre. The founders were confident that if goods and services were produced there would be a demand for them. In framing a constitution, they were interested in establishing a political structure that, among other things, would be conducive to productive activity. With the drafting and ratification of the U.S. Constitution, an experiment was put into motion for testing the effectiveness of supply-side economics. Government was severely restricted in its ability to use taxation and regulation to insert wedges between the value generated by an individual's effort and investment and the return the individual received. This also meant that it was difficult to use the political process to acquire wealth produced by others. In short, the Constitution established a political economy in which the return to productive activity was high relative to the return to nonproductive activity.

This supply-side experiment worked wonderfully. It did not, of course, produce an miracle overnight; but it did provide people with the motivation and freedom to pursue their objectives through hard work and investment. The result was a steady accumulation of human and physical capital and economic wealth. The constitutional limits on government made the policy of supply-side incentives the de facto economic policy of the United States for well over a century, and the long-run effects of this policy were unmistakably successful.

We have inherited an enormously productive economy from the effort and vision of those who came before us. Given this inheritance, it is clearly possible to do well in the short run by consuming the benefits of our productive potential while doing little to maintain it. This is exactly what we have been doing in recent years. Economic productivity was essentially stagnant during the 1970s, yet we increased the size of our houses; spent more on vacations, jewelry, and clothing; enjoyed shorter work weeks; and rapidly increased the

[15]Quoted in James Ring Adams, "Supply-Side Roots of the Founding Fathers," *Wall Street Journal*, 17 November 1982, p. 26.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

amount we spent on governmental services, subsidies, bailouts, and regulations. The effects of policies that encourage consumption while assuming blissfully that productivity will take care of itself have become painfully apparent. Real GNP has grown little as the economy has oscillated between periods of high inflation and high unemployment; major industries with outmoded capital are being surpassed by their foreign counterparts; and government is taxing away more of our income while the quality of important governmental services, such as education and highway maintenance, is declining. In response to the pressures of short-run political expediency, we are squandering our nation's productive capacity. Almost surely our descendants will have less reason to thank us for our economic stewardship and foresight than we have to thank our ancestors for theirs.

The interest in supply-side economics was a predictable response to the problems that have arisen because of the neglect in maintaining our productive capacity. But no matter how well-grounded in sound economic theory supply-side policy is, it will not be able, by itself, to return the economy to productivity and health. As long as politicians have broad discretion in responding to organized interests there can be little hope that they will be able to take the long-run view required by a serious supply-side economic policy. An effective supply-side policy demands more than providing economic advice to politicians. It requires that we recapture the constitutional perspectives that led our founding fathers to place severe limits on the scope of political action and discard the prevailing, but naive, notion that wide-ranging governmental discretion guided by good advice is a force for social progress. It is essential that we broaden our perspective from that of those who James Buchanan refers to as "public-policy economists" to that of Buchanan's "constitutional political economists."[16]

One may debate the particulars of the proposed tax limitation, spending limitation, and balanced budget amendments to the Constitution. None of these proposed amendments is without fault, and none will solve all of our economic problems. But the support and discussion that has accompanied these proposals are healthy signs. People are recognizing that we have to look carefully at the fundamental rules that define and shape our political order if we are to address intelligently many of our current economic problems. This constitutional attitude is probably just as important as the details of

[16]See James M. Buchanan, "Alternative Perspectives on Economics and Public Policy," Cato Institute *Policy Report* 6 (January 1984): 1–5.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the proposed amendments. Recognizing the need for constitutional reform is an essential first step if such reform is to be successful and if the political post-mortem on supply-side economics is to prove premature.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

INSTREAM FLOWS, THE STATE AND VOLUNTARY ACTION

Thomas Greider

The Problem of Instream Flows

The laws comprising the prior appropriation doctrine, the legal basis of water allocation in the Western states, have traditionally discriminated against the private appropriation or purchase of water rights for the purpose of leaving the water in its naturally occurring streambed (see Huffman 1983, pp. 278–80). Beneficial use has historically been defined in terms of water the use of which is expected, by an outside observer, to result in economic gain for the user (Trelease 1974). Additionally, in order to perfect a right to use a quantity of water, the prospective appropriator had to divert the water from the original streambed and thus "develop" the water by putting it to beneficial use (see, generally, Anderson 1982).

The development of this legal position has produced several dramatic consequences. As a result of the diversionary requirement, some streamflows may be totally diverted, thus destroying any unknown instream value the water may have had.[1] The value of the

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Research Associate at the Institute for Social Science Research on Natural Resources, Utah State University, Logan, Utah 84322. He wishes to thank Terry Anderson for his helpful comments on an earlier draft of this paper.

A portion of an early draft of this paper provided evidence for Terry Anderson's book, *Water Crisis: Ending the Policy Drought* (Washington, D.C.: Cato Institute, 1983). Unfortunately, a reference to that draft was overlooked. Terry Anderson respectfully acknowledges the contribution of this paper to his work.—ED.

[1]Occasionally, one sees the argument that the diversionary requirement for the appropriation of water may have made sense in the early period of settlement in the West. Such an argument, however, fails to consider the secondary and long-term consequences of this legal position. Should the state legally prohibit the voluntary allocation of a resource to a use that appears to currently have a near-zero value? In principle, if one accepts the argument that the early prohibition of allocating water to instream uses made sense, then we must answer this affirmatively. Logically, however, this position cannot be consistently maintained. First, it assumes that individuals not facing the opportunity costs associated with a certain allocation can, in fact, determine the value of the resource in a given use.

Second, the position assumes omniscience of the future and a static equilibrium in values held by individuals at any two points in time. If such a position had universal

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

instream flow is unknown precisely because the private appropriation of water for instream purposes has been legally prohibited. In essence, an entire body of potential water bidders has been, and continues to be, prohibited from voluntarily participating in the market for water. The legal exclusion of those who value instream flows (e.g., fishers, and birdwatchers), together with the historical value of zero that has officially (governmentally) been attached to water used to maintain streamflow, have combined to produce a nearly incredible degree of social and political conflict over water use and allocation. The fury and wrath thus generated among those who have been discriminated against by government is quite understandable. While they value the results from instream flows, the state has historically maintained that any other use is more valuable; and they have been prohibited from expressing their values in the economic market for water rights.

The exclusion of potential bidders from the water market has created the situation wherein those individuals who value the use of water for instream purposes turn to the only other force through which they perceive their demands can be potentially realized—the political arena. The remainder of this paper is divided into four sections. First, the arguments for governmental control over the establishment of instream flows are presented. The second section refutes the argument for state control by employing the logic of the property rights paradigm. Evidence of privately owned and managed instream flows is presented in the third part; and a proposal for making the transition to private ownership is offered in the final section.

Government Action Alternative

> To our minds it is utterly inconceivable that a valid appropriation of water can be made under the laws of this state, when the beneficial use of which, after the appropriation is made, will *belong equally to every human being who seeks to enjoy it* . . . .
>
> We are decidedly of the opinion that the beneficial use contemplated in making the appropriation must be one that insures to the *exclusive benefit* of the appropriator and subject to his dominion and control.[2]
>
> [*Lake Shore Duck Club* v. *Lake View Duck Club* 1917]

application, entrepreneurship and the voluntary expression of changing values would effectively be curtailed. The outcome of the application of this position is that government decision makers would determine the social usefulness of every new use for any given resource, if there were any new uses.

[2]Quoted in Kimsey 1975, p. 689; emphasis added.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Instream Flows, A Public Good

The early opinion quoted above on water appropriation in the state of Utah suggests what some have accepted as a significant problem with leaving the provision of instream flows to private economic decisions falling, generally, under the appropriation doctrine. Instream flows and the value derived from such may contain a significant number of the characteristics of a public good (Bradley 1976; Haveman 1972). Indeed, conservationists and environmentalists often seem to maintain this position as clearly stated by an attorney for the National Wildlife Federation: "[I]nstream flows are of necessity a public good" (Meyer 1983, p.9).

Assuming for the moment that instream flows are a public good, one of the characteristics is that the benefits generated by the purchase of instream rights would not accrue exclusively to the owner of those rights. Given the nature of a public good, if it is provided by one individual or group, the existence of free-riders is assured. The free-rider is simply that rational individual who does not invest in a resource because he can enjoy the benefits generated by another's investment in the public good. Thus, under-allocation of water to instream flows—the purchase of which generates positive externalities to be captured by free-riders—will result in the private water market.

For these reasons, some have argued that market-oriented solutions underlying the prior appropriation doctrine are inappropriate for the provision of instream flows. The only alternative, presumably, becomes political allocation of water resources wherein minimum instream flows could be established and protected via governmental power.

A proposed solution often generated from this argument is the establishment of a "safe minimum standard" for streamflows (Bayha 1976; Bradley 1976; Dewsnup 1976; Ciriacy-Wantrup 1952). Under this alternative, the state would be required to specify minimum streamflows, specific to each waterway, necessary to protect natural vegetation, fish, and wildlife. Compensation would then be made to present rights-holders for any damage that may result to their water rights. If, in fact, the maintenance of instream flows is a socially desirable outcome, compensation could be made and the result would leave everyone at least as well-off as before the reallocation, and some individuals would be better off than they were before the transaction. Proponents of government action thus argue that such a reallocation would be in the direction of Pareto optimality (see Hirshleifer 1976; and Hirshleifer, DeHaven, and Milliman 1969, for thorough

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

discussions of this concept). A justification for the state provision and protection of instream flows can thus be derived from presumed peculiarities attached to water that may invalidate the underlying transfer mechanism of the prior appropriation doctrine.

The Public Trust Doctrine

A second and increasingly popular (see Steinhart 1980) attempt at justifying and extending governmental power over allocating water to instream uses has developed around the seminal article by Sax (1970) expounding the virtually limitless possibilities of using the then little known public trust doctrine in protecting the environment. In analyzing the U.S. Supreme Court decision in *Illinois Central Railroad Company* v. *Illinois* (146 U.S. 387, 1892), the case providing the judicial basis of the doctrine, Sax concludes (1970, p. 490):

> When a state holds a resource which is available for the free use of the general public, a court will look with considerable skepticism upon *any* governmental conduct which is calculated *either* to reallocate that resource to more restricted uses *or* to subject public uses to the self-interest of private parties.

In other words, the public trust doctrine appears to provide a foundation for the position that there are certain inalienable rights that accrue to the general public in certain kinds of resources, one of which Sax specifically suggests is water (1970, p. 485). These "social rights" remain even after transfer into private ownership (see Sax 1970; Cohen 1970; Kimsey 1975). And government is the "public guardian" of the social rights (Cohen 1970, p. 388), holding the resources "in trust."

> The [public trust] resources . . . must serve as the welfare of the nation. In the highest sense, therefore, they should be regarded as property held in trust for the use of the race rather than for a single generation and for the use of the nation, rather than for the benefit of a few individuals who may hold them by right of discovery or by purchase.[3]
>
> [National Conservation Commission 1909]

Kimsey (1975) reviewed the extent to which courts have relied on the public trust doctrine in promoting "social rights" in contradistinction to "private rights." He found that courts have restricted the sale of "important public trust assets" to private entities, have prevented transfer of public assets to private ownership when such transfer "would ignore the public interest," and have protected public access to resources that had been previously transferred to private

[3]Quoted in Cohen 1970, p. 388.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ownership (1970, p. 699). In short, when public trust assets are involved, the state cannot abrogate its responsibility as guardian of those assets even upon transfer to private ownership (see Sax 1970).

Those who use the public trust doctrine as the basis of state provision of instream flows generally assert the following. Most, if not all of the states in which the prior appropriation doctrine is applicable have governmentally asserted that actual ownership of water is maintained by "the public" (i.e., the state) even while individuals may obtain a usufruct (use) right (see below, and Anderson 1983b, for a history of this development). Thus, since ownership of the resource is vested in the state for the benefit of the public, the public trust doctrine imposes the fiduciary responsibility on the state to provide for the public interest. And, the argument continues, while economic growth and development were at one time in the public interest and were facilitated by private rights incorporated in the prior appropriation doctrine, instream flows are now in the public interest and thus must be provided by the state for use by the public (see, generally, Sax 1970; Kimsey 1975; Cohen 1970; Radasevich and Sabey 1977; Steinhart 1980).

Refutation of the Necessity for State Control

> A fundamental principle of the law of water courses is that the corpus of water in a natural water course is the property of no one. This absence of private ownership is variously expressed as one of the "negative community," "common," "public," or "the property of the state in trust for the people." The doctrine of public ownership of available water supply has been declared in many states and lays the foundation for state control over the management and the use of water.
>
> [Ditwiler 1975, p. 668]

The Nature of Property Rights

Property rights are social institutions. As such, they are social creations, patterned forms of interrelationships, which help individuals form expectations they can reasonably hold when dealing with other members of the society (Demsetz 1974). Property rights identify, and exist as the institution of, ownership of resources in that they specify who can use a particular resource, and who reaps the benefits and pays the costs associated with usage. "The prevailing system of property rights in the community is, then, the sum of economic and social relations with respect to scarce resources in which individual members stand in relation to each other" (Furubotn and Pejovich 1974, p. 3).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Historically, the property rights attached to beneficial uses of water under the prior appropriation doctrine were private rights (Cuzan 1983; Anderson 1982), which incorporated both the right to exclusive use and the right to transfer the water to others. The social outcome from exclusivity and transferability is that explicit indicators of values held by individuals relative to alternative uses of the resource develop. These explicit indicators ("prices") facilitate the spontaneous allocation and reallocation of a resource to its highest-valued uses (see, among many, Sowell 1980).

Much of the value of private property rights attached to the use of water stems from the certainty regarding the right to exclusive use of water and from the certainty that one can transfer those rights to others who may place a higher value on them. The result, at the societal level, of certainty, exclusivity, and transferability is the dynamic, automatic reallocation of water in a manner consistent with changes in values attached by individuals to different uses.

While private property rights initially formed the basis for the prior appropriation doctrine in the West, common property forms of ownership, where the state is the nominal owner of water, have been increasingly incorporated into law since the first gathering of state legislators. The second legislature of the state of Utah (1897) declared that all waters in the state belonged to the public, i.e., the state (UWRL 1978). In all prior appropriation states, the *use* of the water was to be considered a private right after certain conditions were met; the *ownership* of the water, however, and explicitly the ownership of the water in the stream, remained and so remains today in the hands of the state.

Because the various types of property rights arrangements (i.e., private or public ownership structures) provide varying degrees of certainty with respect to an individual's interaction with others, one can argue that the various forms of institutions that arise after property rights are specified are a result of the specific type of property right relationships stated in the laws. For example, property rights associated with agricultural water use are generally private and are thus protected against damage from other rights-holders. While it is recognized that a problem may exist as to whom the burden of proof of damage or no damage falls, it must also be recognized that new appropriations, changes in use or diversions, and transfers of rights are scrutinized closely by present rights-holders in the effort to protect their exclusive rights to use their water. This careful examination often requires the use of experts paid by the present and potential water owners/users as a reflection of the value they attach to their

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

private use rights.[4] There has not been an equivalent institutional development emanating from state ownership of instream flows, unless one wishes to consider the state water engineers, the Bureau of Reclamation, or the Corps of Engineers as protectors of their rights to instream flows.

The public ownership structure, in addition to yielding a lack of private institutions attempting to protect their exclusive right to instream flows, has legally prohibited individuals who value instream flows from voluntarily expressing that value in the market for water. The state, under public ownership, assumes all authority over how much water will be left in any stream, regardless of the level of demand for instream flows. Until recently, the official position on instream flows was that they were valueless. Thus, all water was subject to diversion if any off-stream use could be shown to have a value greater than zero.

Minimum Requirements

The "minimum requirements" solution proffered by the governmental action alternative would reverse the value of instream flows historically mandated at zero and, ultimately, set the value at the other extreme if the law were inflexible. An infinite value would be placed on instream flows and uses because the water would be prohibited from being transferred to other uses (Ditwiler 1975). If, on the other hand, the requirement was flexible (a much more likely characteristic than inflexibility, see Kimsey 1975), that is, if the decision maker in the appropriate state agency could increase or decrease streamflows as "emergencies" arose or as the "public interest" changed, we should expect emergencies and increased conflict over the "true" public interest to become the norm (Trelease 1974). If this is the case, nothing would be gained but an increased level of uncertainty, the further centralization of decision-making power over water allocation in the state, and increasing levels of political and social

[4]It is unfortunate that some of the benefits accruing to water owners from particular uses must be dissipated in actions designed to protect their exclusive rights to use their water. However, protection costs are necessary or real costs and, as such, account for certain actions or resource allocations not occurring. See Brownstein (1980, p. 97).

If protection costs are high relative to the value of the water in a particular use, then one of two outcomes are possible: Either water will not be allocated to that use or alternative forms of social organization will voluntarily arise (i.e., protective associations) designed to lower the costs of protection. See Anderson and Hill (1975). Neither outcome is costless. The relevant comparison is between the cost of protective actions designed to ensure exclusion and the opportunity costs associated with the foregone uses of the resource, not between perfectly specified and enforced (i.e., "costless") property rights and protection costs.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

conflict. It is certainly not the case that streamflows would necessarily be enhanced.

Ultimately, the establishment of minimum streamflow standards mandates governmental action. Because of this, the following questions become most appropriate and must be addressed by advocates of this position: Who is to decide when an emergency exists? And, whose values are to take priority and represent the public interest at any given time—those who value instream uses or those who value alternative uses?

The Divisible "Public Good" and the Chimerical "Public Trust"

Part of the argument for government control of instream flows was centered on the idea that these flows have certain public good characteristics— the benefits are not divisible and exclusion of free-riders is costly. But instream flows are really no different than the provision of resources for any other use, as the following illustrates.

The values attached to a given resource are not inherent in that resource but are derived from the uses to which it can be put. The value associated with a property right to a resource does not stem from the legal ownership of the resource, but from an ownership of the effective right to use that resource (Coase 1960). While this point may seem trivial, it is quite important. If the use to which a given resource may be put can be individualized in the sense that only those persons willing to pay the costs associated with the provision of the good may capture the primary benefits from use, then the nature of the good is fundamentally private and not public.

As discussed above, the property rights associated with the use of instream flows within the present structure are usually public. That is, because private property rights cannot legally be attached to uses of instream flows, then by definition the provision of these flows becomes a nonexclusionary "public good." This is so, however, precisely because the attachment of private property rights to instream uses has been legally precluded.

Instream flows may represent a classic example of the existence of a governmentally defined public good. Indeed, those who employ both the public good argument and the public trust doctrine to increase state control over water resources may be aware that instream flows are a public good only because of government fiat. When instream flows are considered within the context of the newly favored public trust doctrine, it becomes clear that the state has specifically excluded the possibility of instream flows becoming private goods. The state has thereby mandated that they are public goods. Indeed, it would seem that those who use the public good argument in conjunction

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

with the public trust doctrine are caught in an illogical trap: If instream flows are by their very nature public goods, then the courts could not have found it necessary to develop and apply the public trust doctrine in the effort to maintain the public good nature of the streamflow. It seems reasonable to conclude that the courts have done so precisely because various litigations made it appear as if private property rights were about to become attached to uses of certain resources. In the case of instream flows, if they are indeed public goods, then no one would even attempt to establish exclusivity (i.e., private ownership) because it would be impossible to do so. This, of course, is not the case.

Thus, if one thinks only in terms of the existing structure of property rights, then the provision of instream flows is the provision of a public good. But there is no inherent characteristic associated with use of instream flows that makes this governmentally defined public good immutable. Indeed, if one accepts the proposition that property right structures are social creations, then it follows that there are few (if any) uses of resources that are intrinsically of a public good nature. At minimum, then, the burden of proving a good is "of necessity" a public good falls on those who so argue. Given that the uses associated with instream flows can be privatized (as discussed below), the argument that the provision of these flows is equivalent to the provision of a public good is erroneous.

Exactly what do the proponents of the public trust doctrine believe will be accomplished by employing the doctrine toward the end of protecting instream flows? Will the use of the doctrine, in fact, preserve and protect instream flows? The answer to the first question is fairly obvious. They believe that the doctrine will " prevent the destruction and alteration of resources, and . . . [preserve] public access to resources" (Kimsey 1975, p. 688), and thus protect instream flows. Cohen (1970, p. 392) expresses the prevalent belief that the rules underlying the public trust doctrine

> will result in a shifting to the despoilers of the burden of coming forward with the evidence proving the necessity for despoiling the trust corpus. . . . The despoilers should be required to show that their actions are for the promotion of the public benefit, consistent with the public trust.

Has Cohen suggested anything that would lead one to believe that instream flows would be protected under the public trust doctrine? I think not. Indeed, it may be possible, as Sax notes (1970, p. 482), for any action considered to be in the "public interest" to be incorporated under the doctrine:

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> [I]t hardly seems sensible to ask for a freezing of any future specific configuration of policy judgments, for that result would seriously hamper the government's attempts to cope with the problems caused by changes in the needs and desires of the citizenry.

To emphasize how virtually any action judged (by someone) to be in the "public interest" could be included under the doctrine, Kimsey (1975, p. 687) goes so far as to suggest the diversionary requirements and private property rights initially part of the development of the prior appropriation doctrine could be viewed as legitimate under the public trust doctrine. He is worth quoting at length:

> Although the public trust doctrine does not dictate that these public rights [in instream flows] can never be impaired, it does require that substantial impairment must be justified on the basis of some higher public interest. Since the very foundation of the appropriative system was a critical public interest, it would not be inconsistent with the public trust doctrine to say that the overriding interests of the public during settlement and development of the State of Utah required that the waters of the state be initially directed towards establishing a self-sustaining economy capable of supporting the people of the state.

The question to be addressed by those who advocate the use of the public trust doctrine should be, what exactly would the doctrine accomplish with respect to the protection of instream flows? The answer—no one knows. Indeed, the strongest proponent of the use of the doctrine in environmental litigation, Joseph Sax (1970, p. 553), has suggested the degree of uncertainty inherent in use of the doctrine:

> Perhaps the most striking impression produced by a review of public trust cases in various jurisdictions is the sense of openness which the law provides; there is generally support for whatever decision a court might wish to adopt.

So we come to the second question: Will the public trust doctrine, in fact, preserve and protect instream flows? Unfortunately, the response is again—who knows? But the evidence suggests it would not. A few "victories" might be won using the doctrine in the fight to protect instream flows (see Steinhart 1980; Audubon 1983; Sandler 1983). However, given the adeptness with which the Bureau of Reclamation, the Army Corps of Engineers, and the Tennessee Valley Authority have been able to justify (in terms of the public interest) the Central Arizona Project, the Central Utah Project, the Tellico Dam, the Missouri River Basin Project, and many others too numerous to mention, the odds are certainly against those who wish to preserve instream flows in the name of the public interest by using the public trust doctrine. Indeed, as Trelease (1974, p. 212) suggests,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

use of the public interest in arguments surrounding water allocation is really meaningless, for "the 'public interest' stands neutral, and the only question is, which people get to use the water."

A Misdirected Bias

Those who argue for governmental ownership and protection of instream flows frequently express vehement hostility toward a voluntary market process for the provision and allocation of resources. They profess to firmly believe that the market process has been responsible for the destruction of environmental amenities they value. In its place, they propose that the government, with the assistance of experts with the correct training, and, presumably, the correct values, take over the responsibility for allocating water resources and, in so doing, protect and further the public interest.

Far from being a new idea, the proposal that instream flows should be owned and managed by the state is as old as the settlement of the West: The state has been and continues to be the sole owner and manager of instream flows. It is precisely the monopolization of ownership of instream flows by the public sector that has resulted in a zero value being attached to the uses of instream flows, the consequent potential for all water in streams to be diverted at some time, and the institutional development of the Bureau of Reclamation and the Corps of Engineers. It has been, and continues to be, the state that legally prohibits the market process from allocating water to instream-flow uses by forbidding individuals who value instream flows from bidding for water.

How can we account for this apparent bias? It might be that it is simply the result of the lack of knowledge and understanding about the spontaneous allocational mechanisms of the market process which tend to reflect social values through private action. Unfortunately, there are other possible explanations that may better correspond to contemporary political-economic reality.

There are two broad groups that stand to gain (at least, potentially gain) from further centralization of power over water allocation. One group is comprised of state officials and bureaucrats who may not be overjoyed by the prospect of a voluntary nongovernmental solution. The reasons are obvious: This group currently gains benefits from politically approving or vetoing requested water allocations, transfers, and uses. Indeed, members of this group derive a significant portion of their livelihoods from the governmental solution to instream flows. It is true that under the private, voluntary solution, this group would lose the political power to allocate water and grant favors, and

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

the highly valued personal benefits derived from this power. In short, their arbitrary political power would be eliminated.

A second group that might not welcome a voluntary solution to instream flows is comprised of precisely those organizations which, ironically, stand to further their stated objectives the most from implementing the private solution. Environmentalist (including hunting and fishing) organizations often express what seems to be a very real fear and loathing of the private solution. A partial explanation for their seemingly inherent dislike of the private solution may be that environmental organizations exist not for the purpose of managing their own resources, but for the purpose of persuading state policy makers to decide in their favor. That is, the primary function of environmental organizations may be convincing the state that transferring resources to uses the members of the organizations wish to enjoy is in the "public interest" and will benefit the "social welfare." If they are successful at this type of political transfer activity, there are two outcomes. First, the members of the organizations capture through the political process what they would have had to purchase under the private solution. In this manner, they effectively reduce the cost *to themselves*, but not to society, because all individuals must bear the opportunity costs associated with the political transfer of use rights (Anderson and Hill 1980).

The second outcome, if the environmental organizations are successful, is that they prevent their opponents—the "special interests" in industry and agriculture—from using the resource. This type of winner-take-all outcome, obvious in arguments for minimum streamflow standards, encourages the attitude of "us" versus "them," leading to increases in social conflict as the battlelines are drawn in the political arena. When the state allocates resources, only one party can "win the battle," and, because neither foe faces the opportunity costs of the political allocation of resources, neither side considers the possibility of mutual accommodation. Each party in the political market tends to place an infinite value on its preferred use[5] and, as long as neither side faces the opportunity costs of infinite values, neither will act "as if other social goals mattered" (Baden and Stroup 1981a, p. 36).

[5]Infinite and absolute values are most frequently proposed by advocates of wilderness areas, although all special interests tend to place infinite values on their preferred interests within the political arena. The following is a clear example. "[W]e believe the value of wilderness is absolute . . . . We take the position that wilderness has intrinsic value and should be left alone because it's the rarest commodity on the face of the earth" (Gaylord Nelson, chairman of the Wilderness Society. Quoted in Shute 1983, p. 70).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Only under a private solution can both environmentalist and other special interests win when a mutually agreed-upon transaction is entered. A voluntary market process based on free exchange yields positive-sum results: Each party in the transaction gains by considering the wants of the other parties. Under the governmental alternative, there must be winners and losers. Resource transfers under this structure are, at best, zero-sum or, more likely, negative-sum (Anderson and Hill 1980). Unfortunately, it appears that it is extremely important to environmentalist organizations that other "special interests" be losers.

The Voluntary Alternative

The historical evidence surrounding the care of instream flows under public ownership indicates, with little doubt, that those of us who place a high value on the amenities produced from these flows cannot afford to trust the state's administration. Which alternative, then, governmental action or private ownership, is more likely to protect instream flows? Fortunately, there is substantial evidence that leads us to the solution.

The English, Scots, and Welsh have a rich history of private ownership of land and water resources (see Bish 1977; Johnson 1971; and especially Sutherland 1968). Most resource utilization is governed by private property rights in one form or another, and a given resource is frequently subject to a diverse set of rights:

> Thus an area of land may give one man the right to collect rent for it, another the right to farm it and another the right to shoot over it. But to own the freehold of land is to own a bundle of rights over the land which can effectively exclude any other party setting foot upon it.
>
> [Sutherland 1968, p. 146]

What Sutherland describes is, of course, the classic definition of private property: The ability to capture the benefits and costs associated with a particular resource and to exclude non-cost-bearing individuals from reaping benefits. The same property rights structure has been applied to the ownership and use of instream water flows, a primary use of which is fishing.

Where an allocation of a resource to a particular use is not legally prohibited, and if the use has value as evidenced by an individual's willingness to pay the opportunity cost associated with the right to use, then we expect owners and prospective owners under a private property rights structure to voluntarily allocate a portion of the resource to that use. In England, in the early 1900s, there was little value attached to fishing activities by non-landowners and non-wealthy

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

individuals (i.e., by a *majority* of the members of society). Fishing rights thus had little social value and certainly would not have been considered part of "the public interest." The owners of streams, however, maintained their fisheries. They did so for their exclusive use because *they* valued *their* fisheries; and they had little concern for the lack of "social value" attached to fisheries by non-owners.

Today, social values are different. Demand for fishing and the willingness to pay exhibited by non-owners have increased dramatically, and "there are few landowners . . . who can afford to ignore the commercial aspect of the sporting rights which they own" (Sutherland 1968, p. 110). Indeed, the demand for fishing does not go unnoticed and a variety of types and qualities of fishing activities are provided by private, voluntary actions. While some salmon rivers command a relatively high price (a reflection of the value of fishing and the care given to the fishery),[6] other owners cater to the demands of the average urban resident:

> In the 1960s and 1970s smaller, privately managed fisheries that offered exclusivity in exchange for higher rod fees began to break out like an aquatic rush around the country [England]. Now every city and major town . . . has first-rate trout fishing within easy reach, and at an affordable price.
>
> [Clarke 1979, p. 219]

It is not necessarily the case that even the best salmon fisheries are beyond the reach of the non-wealthy individual. Angling associations in various locales often charge by the week or rod for the privilege of fishing their waters. For example, Grantown-on-Spey, the Spey being a prime Scottish salmon fishery, charges $25 per week for the right to fish approximately seven miles of the river (Zern 1981; see also Sosin 1981).

Because easily determined values (i.e., prices) are attached to the right to fish in streams, we would expect investment by owners of instream waters both in the management for improved fisheries and in protective actions to safeguard their exclusive rights to use. This is precisely what has occurred. With respect to the investment in fishery improvements, Zahner (1980, p. 16) expresses this care in a striking way:

> No people have toyed with the works of Nature more, and in the doing harmed them less, than the British. . . . To maintain their houses as homes, they retained housekeepers. To keep a proper

[6]In a recent sale of a Scottish estate, which included fishing rights to just under one mile on the Tweed River (a prime salmon fishery), the fishing rights alone sold for $220,000. See Zern (1981).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> garden and park, they had groundskeepers. Gameskeepers for stag and grouse. Then, as keepers of the kept, even gatekeepers to further secure things. And eventually, it was for the British to devise the ultimate in the art of maintenance—the river keeper.
>
> Now, the name itself could easily be misinterpreted—as it has from time to time by our American "river keepers," whom we call "the Corps of Engineers." To keep a river from doing what it is supposed to do would be noxious to the British, as it is to many anglers.

While protection costs to maintain exclusivity or desired use are a problem under any property rights structure, it is more likely that innovative techniques would be implemented under private property structures than under public ownership. This is because the individual owner gains all (or, at least, most) of the benefits flowing from the innovative techniques. Sutherland (1968, pp. 114–15) provides an example of a particularly innovative private, voluntary solution to one landowner's problem of protection costs:

> One large estate owner ... who was considerably troubled by poachers, solved his problem by inviting the most hardened poacher to form a fishing club, and provided two lochs and a stretch of river for the purpose. It proved highly successful. The club members themselves contributed to the restocking of the water and the landowner's private rights were assiduously respected.

This type of innovative solution would be most unlikely (if not impossible) under public ownership of the fishery. It is, indeed, unfortunate that there exist individuals who engage in thievery, but, while unfortunate, it is also a part of reality and exists to a higher degree than would otherwise be the case because of public ownership. Under private ownership structures, the individual owner rather than the state has a vested interest in achieving the most protection for the least cost because the owner captures the residual that remains. Hence, while the innovative technique employed by the owner in the above example seems to legitimize or benefit poachers, it actually proved quite beneficial to the individual owner and curbed the problem.

Under the British system of property rights, what happens to the owner of the fishery if he or she destroys or diminishes the quality of the resource for whatever purpose? Quite simply, the *owner* loses; the owner loses all the value that other individuals would have been willing to pay him to maintain or improve the quality of his fishery. Again, Sutherland (1968, pp. 113–14) suggests why the private owner is not likely to misuse his property:

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

> That sporting rights are a desirable amenity is undoubted, but it must be remembered that without careful preservation much of the amenity would not exist. The good-natured farmer who allows anyone to shoot over his land, and does nothing to preserve his stocks, will soon find that there is nothing left to shoot. . . . If he invests in improving his sporting amenities he is surely entitled to make what profit he can from his enterprise. That this should result in the rationing of the commodity by price is no more deplorable than the fact that Dover sole costs more than herring.

On the other hand, who loses when the resource is owned by the state? The person who "manages" the resource certainly does not bear the entire costs of destruction precisely because he is not the owner of the resource. The resource is, by definition, owned by everyone, in common, and thus most (if not all) citizens lose.

Conclusion: Getting from Here to There

The adoption of the government "solution" by those who value instream flows indicates a remarkable degree of faith in the political arena that has produced the American counterpart of the English river keepers—the Bureau of Reclamation and the Corps of Engineers—the actions of which have been precisely to "keep a river from doing what it is supposed to do." Faith in the bureau and the corps has never been a dominant characteristic of most environmentalists. Nevertheless, many of them now seem to be placing their trust in these or other government organizations to provide solutions to the problem of instream flows. Faith is certainly not a bad feature for an individual to possess, but it should be tempered with reality. The reality produced by faith in the state to provide and protect any valued commodity or resource has been characterized by conflict, hostility, and "emergencies," often justifying perverse actions in the name of the "public interest." There is no reason to assume that reliance on the state for the solution to instream flows would result in a more positive outcome. Indeed, there is every reason to believe the opposite, since streamflows would be at the mercy of government bureaucrats who increase their wealth by allocating water through political rather than voluntary means.

The solution to the problem of instream flows is theoretically, logically, and empirically obvious. Indeed, it is simply the manifestation of what the British and such groups as Ducks Unlimited and the Nature Conservancy have practiced for a long time: If one wants the best possible care to be given a resource, then private, voluntary solutions are superior to state or public ownership. But, how do we get from the point of centralized control at which we find ourselves

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

today to the private solution? How do we make the transition to voluntary action?

While it may sound contradictory, perhaps the only way to attain the private solution is to rely on governmental action—but a type of action very different from that for which the state is notorious. While past governmental action has invariably resulted in an increase in the power of the state over water use and allocation, the proposed action would result in a drastic reduction, and eventual elimination of centralized control. The proposal is as follows.

Irrigated agriculture is, by far, the dominant use of water in the Western states and is responsible for most of the diversion of water from streams. It has also received one of the largest subsidies in the history of the United States (see Anderson 1983a; and Berkman and Viscusi 1973), with the possible exception of the military-industrial complex. Further, when streams dry up in the summer months or are flooded out of existence, the standard beneficiaries have been agriculturalists.[7]

It is commonly recognized that irrigation water in the West is priced below what might otherwise be the case in the absence of massive subsidies. This has produced a quantity of water in agricultural use above the level that would otherwise be voluntarily allocated to agriculture in the absence of "cheap" water. Should the government withdraw the subsidy, the price to agriculturalists of using the water would rise, and a certain number of them would leave agriculture. This would increase the water available for reallocation to higher-valued uses.

The second stage in the transition is one that many might find incomprehensible given the arguments developed above. Nevertheless, it is justified on the basis of previous state action. As a result of agriculturalists (and others) paying a higher, non-subsidized price

[7]This may be changing, however, as the following quote from Floyd E. Dominy, former commissioner of the Bureau of Reclamation, suggests (quoted in Berkman and Viscusi 1973, p. 205):

> The major factor in our conservative benefit estimates [of past water resources projects] . . . is our inability to place a dollar value on the intangible effects . . . [which] include stabilization of income, creation of job opportunities, provision of economic flexibility, redistribution of income, dispersal of population, resource preservation and the general economic and social well-being of people. . . . On the other hand, the adverse intangible effects of projects that involve minor infringements of wilderness areas or national parks consistently become of over-riding significance.

Apparently, the beneficiaries of Bureau of Reclamation projects now include virtually everyone, with the possible exception of those who bring to light those "minor infringements of wilderness areas or national parks."

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

for water, the state will reap a considerable amount of "new" revenue. Since the state created the problem of instream flows by legislative fiat that prohibited those who valued instream flows from purchasing water rights, and since the agriculturalists were primary beneficiaries of the exclusion, an appropriate recipient of the new revenue would seem to be those against whom the state has traditionally discriminated.

For a specified number of years, the revenue would be given to environmentalist organizations for the purpose of purchasing private use rights to instream flows wherever they deemed appropriate and could find willing sellers. This transfer should cost the general public no more than the present subsidy of water to agriculture, although perhaps food prices might rise because of the higher price of water. After the specified length of time, the revenue would be used to pay that portion of the public debt that has accrued as a result of governmental irrigation projects. Upon retirement of the debt, fee simple ownership over the water would transfer to those who purchased it, and the state would completely withdraw from all control over use and allocation of water. The transition to the private solution would be complete.

It is not my intention for the above proposal to be considered final. It is, however, a heuristic step in making the transition to private instream flows. Further, it should appeal to environmentalist organizations which, at present, are perhaps the most formidable opponents to the private ownership of instream flows. Finally, the proposal should facilitate what some have suggested should be a natural coalition between environmentalists, libertarians, and fiscal conservatives (Baden and Stroup 1981b, pp. 6–7). If so, we will have taken a giant step toward equity, efficiency, environmental quality, and freedom.

References

Anderson, T. L. "Institutional Underpinnings of the Water Crises." *Cato Journal* 2 (Winter 1982): 759–92.

Anderson, T. L. *Water Crisis: Ending the Policy Drought*. Washington, D.C.: Cato Institute, 1983a.

Anderson, T. L., ed. *Water Resources: Scarce Resource Allocation, Bureaucracy, and the Environment*. Cambridge, Mass.: Pacific Institute and Ballinger Publishing Co., 1983b.

Anderson, T. L. and Hill, P. J. *The Birth of a Transfer Society*. Stanford: Hoover Institution Press, 1980.

Anderson, T. L. and Hill, P. J. "The Evolution of Property Rights: A Study of American West." *Journal of Law and Economics* 18 (April 1975): 163–79.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Audubon. "Victory on Mono Lake." *Audubon* 85 (May 1983): 143–44.

Baden J. and Stroup, R. "Saving the Wilderness: A Radical Proposal." *Reason* 13 (July 1981a): 28–36.

Baden, J. and Stroup, R. "Introduction." In J. Baden and R. Stroup, eds., *Bureaucracy vs. Environment: The Environmental Cost of Bureaucratic Governance*, pp. 1–8. Ann Arbor: The University of Michigan Press, 1981b.

Bayha, K. "Instream Flows—The Big Picture." In J. F. Orsborn and C. H. Allman, eds., *Proceedings of the Symposium and Specialty Conference on Instream Flow Needs*, vol. 1, pp. 95–131. Bethesda, Md.: American Fisheries Society, 1976.

Berkman, R. L. and Viscusi, W. K. *Damming the West*. New York: Grossman Publishers, 1973.

Bish, R. L. "Environmental Resource Management: Public or Private?" In G. Hardin and J. Baden, eds., *Managing The Commons*, pp. 217–28. San Francisco: W. H. Freeman and Co., 1977.

Bradley, M. D. "Institutional and Policy Aspects of Instream Flow Needs." In J. F. Orsborn and C. H. Allman, eds., *Proceedings of the Symposium and Specialty Conference on Instream Flow Needs*, vol. 1, pp. 79–94. Bethesda, Md.: American Fisheries Society, 1976.

Brownstein, B. P. "Pareto Optimality, External Benefits and Public Goods: A Subjectivist Approach." *Journal of Libertarian Studies* 4 (Winter 1980): 93–106.

Ciriacy-Wantrup, S. V. *Resource Conservation, Economics, and Policies*. Berkeley: University of California Press, 1952.

Clarke, B. "The Nymph in Still Water." In J. M. Migel and L. M. Wright, eds. *The Masters on the Nymph*, pp. 219–29. New York: Nick Lyons Books, 1979.

Coase, R. "The Problem of Social Cost." *Journal of Law and Economics* 3 (October 1960): 1–44.

Cohen, B. S. "The Constitution, The Public Trust Doctrine, and The Environment." *Utah Law Review* 3 (June 1970): 388–94.

Cuzan, A. G. "Appropriators Versus Expropriators: The Political Economy of Water in the West." In T. L. Anderson, ed., *Water Rights: Scarce Resource Allocation, Bureaucracy, and the Environment*, pp. 13–44. Cambridge, Mass.: Pacific Institute and Ballinger Publishing Co., 1983.

Demsetz, H. "Toward a Theory of Property Rights." In E. G. Furubotn and S. Pejovich, eds. *The Economics of Property Rights*, pp. 31–42. Cambridge, Mass.: Ballinger Publishing Co., 1974.

Dewsnup, R. L. "Protecting Instream Flows under State Laws." In J. F. Orsborn and C. H. Allman, eds., *Proceedings of the Symposium and Specialty Conference on Instream Flow Needs*, vol. 1, pp. 17–54. Bethesda, Md.: American Fisheries Society, 1976.

Ditwiler, C. D. "Water Problems and Property Rights—An Economic Perspective." *Natural Resources Journal* 15 (October 1975): 663–80.

Furubotn, E. G. and S. Pejovich "Introduction: The New Property Rights Literature." In E. G. Furubotn and S. Pejovich, eds., *The Economics of Property Rights*, pp. 1–9. Cambridge, Mass.: Ballinger Publishing Co., 1974.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Haveman, R. H. *The Economic Performance of Public Investment: An Ex-Post Evaluation of Water Resources Investments.* Baltimore: The Johns Hopkins University Press, 1972.

Hirshleifer, J. *Price Theory and Applications.* Englewood Cliffs, N.J.: Prentice-Hall, 1976.

Hirshleifer, J.; DeHaven, J. C.; and Milliman, J. W. *Water Supply: Economics, Technology, and Policy.* Chicago: University of Chicago Press, 1969.

Huffman, J. "Instream Water Use: Public and Private Alternatives." In T. L. Anderson, ed., *Water Rights: Scarce Resource Allocation, Bureaucracy, and the Environment*, pp. 249–82. Cambridge, Mass.: Pacific Institute and Ballinger Publishing Co., 1983.

Johnson, W. A. *Public Parks on Private Lands in England and Wales.* Baltimore: The Johns Hopkins University Press, 1971.

Kimsey, R. A. "Water Allocation in Utah—Protection of Instream Uses." *Utah Law Review* 3 (Fall 1975): 687–707.

Lake Shore Duck Club v. Lake View Duck Club. 50 Utah 76, 166, p. 309 (1917).

Meyer, C. Comment on "Solving the Water Crisis." Cato Institute *Policy Report* 5 (July 1983): 6–9, 11.

Radasevich, G. S. and Sabey, M. B. "Water Rights, Eminent Domain, and the Public Trust." *Water Resources Bulletin* 13 (August 1977): 747–57.

Sandler, R. "Mono Lake Changes the Law." *Environment* 25 (May 1983): 5, 43–44.

Sax, J. "The Public Trust Doctrine in Natural Resource Law: Effective Judicial Intervention." *Michigan Law Review* 68 (January 1970): 471–566.

Shute, N. "The Movement to Sell America." *Outside* 8 (September 1983): 37–43, 68–70.

Sosin, M. "Trout and Salmon, Scottish Style." *Sports Afield* 186 (August 1981): 35–36.

Sowell, T. *Knowledge and Decisions.* New York: Basic Books, 1980.

Steinhart, P. "The City and The Inland Sea." *Audubon* 82 (September 1980): 98–125.

Sutherland, D. *The Landowners.* London: Anthony Blond, 1968.

Trelease, F. J. "The Model Water Code." *Natural Resources Journal* 14 (April 1974): 207–30.

Utah Water Research Laboratory (UWRL). *Utah Water Laws, Politics, and Institutions.* Logan, Utah: Utah State University, 1978.

Zahner, D. "The Man Who Kept the River." *Fly Fisherman* 12 (December 1980): 16–17.

Zern, E. "By Yon Bonny Banks." *Field and Stream* 86 (September 1981): 120.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

DEREGULATING ELECTRIC UTILITIES: A MARKET-PROCESS APPROACH

Douglas A. Houston

Introduction

The basic assumptions on which public utility regulation have been built are increasingly challenged. Longstanding policy prescriptions no longer have unwavering support from academicians, politicians, or executives in the regulated industries. There appears to be a widespread recognition that, due to exhaustion of scale economies, the generation sector of the electricity industry may accommodate a competitive market structure.[1] But can any of the many proposals for rearranging the industry enhance the competitive market process? It would be foolhardy to assume deregulation reforms necessarily mean more competition without examining what these proposals can realistically be expected to accomplish.

Many deregulation schemes call for divestiture of currently integrated generation and transmission functions,[2] while less amibitious

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Assistant Professor of Business Economics at the University of Kansas, Lawrence, Kans. 66045.

[1]See L. R. Christensen and W. H. Greene, "Economies of Scale in U.S. Electric Power Generation," *Journal of Political Economy* 84 (August 1976): 655–76.

[2]See William W. Berry, "The Case for Competition in the Electric Utility Industry," *Public Utilities Fortnightly* 110 (September 1982): 12–20. Berry presents one of the few pro-divestiture viewpoints within higher management of investor-owned electric utilities in the United States. Also see Matthew Cohen, "Efficiency and Competition in the Electric-Power Industry," *Yale Law Journal* 88 (1979): 1511–49. Cohen presents one of the more ambitious divestiture proposals. A modified version of Cohen's proposals appears in *Promoting Efficiency in the Electricity Sector*, Congress of the United States, Congressional Budget Office (Washington, D.C.: Government Printing Office, November 1982).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

reforms require forcing access to sources of power for independent distributors.[3] In a typical deregulation proposal:

> A regional transmission company, which would be regulated or government-owned, would purchase electricity from competing, separate generating companies and would sell it to all distributors in the regions.[4]

These reformists assume that transmission of electricity would remain a natural monopoly. Therefore, they argue that single ownership of transmission and generation facilities would defeat the purposes of competitive reform in generation; integrated firms would continue to behave as monopolists. Their proposals present an irony: To create one of the conditions for perfect competition (the existence of a large number of competing firms) in the generation of electricity, the force of government must be used either to sever existing integration or to force contracts that utilities would not voluntarily make. The possible costs of disintegration and the gains from vertical integration are either ignored or lightly dismissed. Instead, reformists accept as an article of faith that no good can come from vertical integration; thus, they argue that disintegrating existing firms and disallowing industry entry by vertically integrated firms will do no harm. Their arguments seem designed less to aid our understanding of how the industry operates than to find the "obvious" flaws in it so they can then proceed with their policy recommendations.

In contrast to these partial reforms, this paper offers a deregulation proposal that advocates the removal of economic regulation at all levels of activity. Such change is not without transitional cost. Consequently, the removal of economic regulation in the proposal is conditioned by the final consumer's willingness to accept an open market. The consumer is given rights to an open market, a "market option," which he then can exercise, assign to another party, or hold unsigned. Consumers holding unsigned options would retain utility commission regulation over their transactions. The market option, coupled with removal of legal entry barriers at *all* levels of activity, provides the means of realistically testing the net value (or cost) of economic regulation.

The paper is organized as follows. The following section examines the forces that affect the competitive process in the electricity

[3]See Joe E. Pace and John H. Landon, "Introducing Competition into the Electric Utility Industry: An Economic Appraisal," *Energy Law Journal* 3 (1982): 1–65; also see James F. Fairman and John C. Scott, "Transmission, Power Pools, and Competition in the Electric Utility Industry," *Hastings Law Journal* 28 (May 1977): 1159–1207.

[4]Irwin M. Stelzer, "Electric Utilities—Next Stop for Deregulators?" *Regulation* 6 (July/August 1982): 30.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

industry. Next, proposals for partial deregulation are analyzed. Last, a proposal for attaining complete deregulation—the emergence of an open, competitive electricity industry—is described.

The Competitive Process in Electricity

The Natural Monopoly Argument

The traditional basis for electric utility regulation is the natural monopoly argument. In a natural monopoly, the cost of service would rise dramatically if duplicative services were operating. "The principle source of this tendency (toward economies of scale) is the necessity of making a large investment merely in order to be in a position to serve customers on demand."[5]

Standard doctrine is that the long-lived, highly specialized assets involved with local transmission and long-distance distribution of electricity embody the characteristics of natural monopoly. Either by building a larger initial system or by increasing the capacity of an existing system, a single distributor could provide additional service at much lower cost per unit of output than a number of firms. Although the matter of natural monoply in distribution and transmission cannot be easily settled by examining historical records,[6] it can be assumed for the exposition in this paper that direct rivalry for most electricity markets would be uncommon, even without regulatory restrictions. Public utility law that allows only a single franchised supplier supposedly prevents an entrant from destroying the existing firm as well as itself.

Even if the claims of substantial scale economies in both the transmission and local distribution of electricity are correct, this does little to explain the nature of the perceived "public utility problem": a dearth of direct competition and, consequently, significant market power over consumers by suppliers. As Harold Demsetz has pointed out, the existence of a natural monopoly is irrelevant to a determination of the number of rival bidders for that monopoly. In other words, if a number of potential suppliers has access to the key strategic assets, bidding for a franchise (bidding for the field) might occur

[5]Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. 2 (New York: John Wiley & Sons, 1971), p. 119.

[6]In the late 19th century, the practice of openly allowing operating privileges among electricity utilities was widely discontinued. A number of investigations were undertaken in the early 20th century, the aim of which was to show that ". . . competition did not achieve its purpose." These appear to be little more than ex post justifications for entry barriers. See Burton N. Behling, "Competition and Monopoly in Public Utility Industries," *University of Illinois Bulletin* 35 (August 1983): 21.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

and market power would be constrained by the forces of competition.[7] The form of competition suggested by Demsetz is not an open market process because, invariably, a government agent is called upon to decide the winning franchisee, forceably excluding other participants from later entry. Further, the application to areas where service is already established could be made only by first removing ownership from the current supplier. Last, in the electricity industry, there would remain critical transaction problems with the contract winner, and later opportunistic behavior could reduce the effectiveness of "bidding for the field."

Although Demsetz's proposal may not be a direct means of injecting competition into the electric utility industry, his major contribution was to expand our understanding of market process in sectors where few competitors exist at any given time. Immediate competition may be limited, but competitive behavior can be stimulated by potential alterations in the ownership structure of the industry. We cannot appraise the competitive prospects for the electricity industry by considering behaviors of participants given an existing ownership pattern. Instead, we must analyze *potential* organizational configurations to be able to foretell how overwhelming a single supplier might be. Thus, the standard monopoly argument that a single supplier has no supply-side constraints is open to question.

Entry and Vertical Integration

As long as there are no government restrictions on entry or exit from the electricity industry, we may expect some long-run, "structural" strategies to constrain the behavior of a single supplier, even if the conditions of natural monopoly hold. These strategies require the ability of market participants to rearrange the pattern of ownership and to enter (or leave) the industry freely, using the most efficient organizational form. Unfortunately, the electric utility industry provides few clues on the nature or strength of this kind of competition because the entry and exit conditions have been firmly controlled by government. Typically, one firm is franchised to sell in a territory, and the building of transmission and distribution systems is subject to legal certification and the selective granting of eminent domain powers.

For entry to be a powerful constraint on suppliers, an entrant must be able to organize his operation and arrange his asset holdings in an efficient manner. It is noteworthy that most electric utilities are

[7]Harold Demsetz, "Why Regulate Utilities?" *Journal of Law and Economics* 11 (April 1968): 55–56.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

integrated through all stages of production, although vertical integration may not be the result of direct economies of scale.[8] Many industry observers have denied any value to vertical integration. A typical perception is: "Utilities strive to integrate forward to obtain the security of a guaranteed outlet for their product and backward for a dependable supply of bulk power. But vertical integration does not significantly reduce the cost of operation at any stage of the industry."[9] Based on this view, the separation of ownership of the stages of production will not increase costs.

Is vertical integration an efficient organizational form? The answer to this question will provide insights into the necessary conditions for furthering competition in the industry. If we accept the presumption of few direct economies,[10] the prevalence of vertical integration in the electricity industry will require another rationale. It can be explained by a simple example. Assume a particular transmission channel is necessary to move electricity from a single producer at point A to consumers grouped at point B. Like a river, the transmission channel involves the use of assets that, once in place, would be very costly to move or duplicate.[11] The firm owning the transmission corridor controls long-lived, highly specialized assets that perform an inflexible activity, that of moving electricity between points A and B.[12] Concurrently, the users of this service, the producer at A and

[8]"While no study has been made of the economies of vertical integration between generation-transmission companies and distribution utilities, it is difficult to envision many direct economies. . . ." Leonard W. Weiss, "Antitrust in the Electric Power Industry," in *Promoting Competition in Regulated Markets*, ed. Almarin Phillips (Washington, D.C.: Brookings Institution, 1976), p. 156.

[9]Cohen, p. 1524.

[10]Most policy writings on electric utilities simply brush aside the thought of economies from vertical integration, although there is no empirical evidence to my knowledge. For example, see James E. Meeks, "Concentration in the Electric Power Industry: The Impact of Antitrust Policy," *Columbia Law Review* 72 (1972): 76.

[11]An electricity transmission system is quite unlike a river in many ways. The flow is determined largely by the physical and electrical characteristics across the entire system. While this difference from traffic flow on a river is important in considering control problems, the use of this analogy is still appropriate for understanding the basic contractual relationships. See W. S. White, Jr., "A Closer Look at Electric Utility Deregulation," *Public Utilities Fortnightly* 109 (January 1982): 19–23.

[12]An issue in building a transmission corridor is the task of assembling the numerous private property rights over which the transmission lines will run. Historically, this problem has been simplified for the utilities by the use of eminent domain law to take private property. The right is invariably given to one supplier per territory. This paper does not evaluate the important issue of how this legal device alters the industry. The reform suggested later in the paper is predicated upon use of eminent domain by no party. For an interesting economic evaluation, see Patricia Munch, "An Economic Analysis of Eminent Domain," *Journal of Political Economy* 84 (June 1976): 473–97.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

consumers at B, will be performing activities that are highly specialized to this particular transmission system's service; options for delivery may be nonexistent in the present, and extremely costly to develop. Opening another channel, once one is moving electricity between points A and B, is as unlikely to occur as the opening of a canal parallel to an existing navigable river.

The transmission system forms a "bottleneck" that users cannot evade at low cost. The market power of the transmission system owner is clear. He may extract, in the short run, large quasi-rents equal to the valuation for the service to his users less his operating costs. Over time, these rents will be dissipated in two ways. Entry may occur, enticed by large economic profits from transmission, driving the return on investment to a normal profit rate. On the other hand, if there are no entry possibilities (by substitution in either transmission or end use), the rents would become capitalized into the transmission system's asset value.

The point here, however, is not that market power is embodied in the ownership of the transmission system, but that the market power is subject to much volatility over time. Pricing possibilities will fluctuate directly with the very limited number of demands placed on the system. With a very specialized asset, variations in valuation come from a very small user population; consequently, bargaining power and pricing possibilities can be dramatically altered. For example, the emergence of a new user, whose valuation for the complete transmission services exceeds that of producer A, could cause producer A to lose his complete market. Of course, efficiency is served by reallocation of resources to their highest incremental valuations. But if the problem (how to enter the electricity industry most efficiently) is considered from the long run, then these transaction risks become an important economic cost factor that rational agents will attempt to reduce.

Long-term contracts are a means of reducing the transaction risk, but as the sole basis of service they may not effectively deal with the problem. Long-term contracts are costly to administer and enforce, and there are numerous ways for either party to alter price (or service characteristics) in an opportunistic attempt to gain. This is particularly troublesome if demand or technology are altered considerably after the contract signing. Regardless of the details of any contract, producers or consumers, given the opportunity to gain, have the incentive to search for the means to evade a contract's terms, even in a "regulatory" contract.[13]

[13]See Oliver Williamson, "Franchise Bidding for Natural Monopolies—in General and with Respect to CATV," *Bell Journal of Economics* 7 (Spring 1976): 73–104. For a view of regulation as a form of contract, see Victor P. Goldberg, "Toward an Expanded Theory of Contracts," *Journal of Economic Issues* 10 (March 1976): 45–61.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Strong incentives exist to provide a structure of exchanges that economizes on transaction costs.[14] An entrant in the electricity industry would be well aware of the transaction risks caused by the large "sunk" investment in transmission assets that are both durable and specialized in use.[15] On the other hand, the electricity industry does not present a picture of complete immobility of assets used in generation and transmission. Clearly, these two stages may muster options that reduce the ongoing transaction (market-power) problem. But given the sparse evidence of other cost advantages, transaction risk avoidance may be a principal cause of the vertical integration that spans the generation, transmission, and distribution stages.

Note, however, that as the transaction problem afflicts upstream transactions, it is also quite evident at the consumer level. Why has there been no integration here too, bringing the final transaction into the vertically integrated firm? Clearly, the institution of public utility regulation has been developed with the intention of dealing with this market-power question. Whether it efficiently fulfills that function is a question that cannot be directly answered because of the legal exclusion of alternative organizational forms that might compete with regulation. If consumers (or their organizations) could build or acquire distribution and transmission channels back to alternate producers (or generate themselves), they might reduce greatly a single supplier's market power. Entry restrictions placed on the electricity market to reduce "wasteful duplication" are quite wrongheaded if a threat of entry is the least costly means of constraining the market power of the existing supplier.[16] Resources rationally committed to increasing industry capacity in order to reduce market power may not be wasted, but rather may support productive activity.[17]

Natural monopoly is the economic basis for public utility regulation practiced in all electricity markets in the United States. However, natural monopoly does not imply that there cannot be strong competitive pressure. Competition in this industry, given current technologies, is greatly dependent upon the ability of market

[14]See Oliver Williamson, "The Modern Corporation: Origins, Evolution Attributes," *Journal of Economic Literature* 19 (1981): 1537–70.

[15]Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics* 21 (1978): 297–325. Economists Klein, Crawford, and Alchian have suggested tht such transaction risk has lead to joint ownership of oil pipelines by integrated producers-refiners to remove the market-power threat at both ends of the pipeline.

[16]Elizabeth E. Bailey, "Contestability and the Design of Regulatory and Antitrust Policy," *American Economic Review* 71 (May 1981): 178–83.

[17]See James M. Buchanan, "Rent Seeking and Proft Seeking," in *Toward a Theory of the Rent-Seeking Society*, ed. James M. Buchanan, Robert D. Tollison, and Gordon Tullock (College Station: Texas A&M University Press, 1980), pp. 3–15.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

participants to rearrange ownership and the structure of the market itself. These tasks are "long run" in nature. Vertical integration may be a highly efficient organizational structure in the electricity industry, given the risks incurred in market transactions; thus, entry restrictions at any industry stage may greatly reduce efficiency and consequently hinder the competitive process in the electricity industry. This argument, as will be discussed in the next section, is in direct conflict with the typical deregulationist proposal for the industry that calls for vertical *divestitures* between the generation and transmission stages, and provides no opportunity for integration in which consumers are voluntarily involved.

Proposals for Deregulation and Divestiture

A number of visions of competition in the electric utility industry have moved through the public policy arena in the last few decades. Few industry analysts have considered direct competition for retail customers to be a reasonable option. While there is some direct competition in the United States between municipal and privately owned firms, direct competition would probably be uncommon in an unregulated marketplace.[18] On the other hand, wholesale competition among generating firms for industrial or local distribution system customers is seen as more likely to occur and has received widespread support as a realistic policy objective. It is argued that, in the generation stage, cost reductions from increases in output are no longer significant over a broad range of firm sizes; thus efficient generating firms, of smaller plant size than the largest currently in operation, could prosper.

Divestiture deregulation proposals promise the removal of certain instruments of economic regulation, especially lifting rate regulation from the generating firms in the industry. There are numerous proposals to deregulate the generation stage of the electricity industry,[19]

[18]Walter Primeaux is one of the few researchers to argue that direct, head-to-head rivalry could be a strong competitive force in some electricity markets. See Walter J. Primeaux, "The Monopoly Market in Electric Utilities," in *Promoting Competition in Regulated Markets*, ed. Almarin Phillips (Washington, D.C.: Brookings Institution, 1975), pp. 175–200. Also see Jan Bellamy, "2 Utilities are Better Than One," *Reason* 13 (October 1981): 23–30. Other forms of electricity competition include competition for fringe territories, "yardstick" competition (comparing performance of privately owned utilities with that of similar public utilities), and competition for new industrial plant locations. Most analysts view these as helpful, but rarely significant, in limiting the market power of an integrated utility.

[19]Because the purpose of this section is only to examine the major common features of these divestiture reforms, no attempt is made to provide insight into the unique features of any of the proposals.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

but all have five common elements: (1) severing the vertical integration in ownership of the generation, transmission and distribution stages; (2) removing rate regulation from the generating firms' sales; (3) removing entry barriers in the generation stage; (4) creating a separately owned, regional transmission system (a government owned or franchised monopoly) that has an obligation to coordinate operations and planning in the region, and sell electricity on a cost-plus basis or act as a broker between generating firms and distributors; and (5) applying continued economic regulation (or government ownership) to local distribution systems, with no direct competition allowed for retail customers.

In sum, the kind of market that most industry observers expect can be competitive involves bulk transactions between independent generation companies and wholesales.[20] Much of the literature advocating more competition in the electricity industry, therefore, has suggested legal reforms to improve access to other sources of power for local independent distributors and wholesale consumers without substantially altering the industry's ownership structure. To these reformists, rivalry can be spurred by strengthening the requirements for wheeling (the use of an intervening utility's transmission lines to bring power from a remote supplier to a wholesaler customer), and actively using antitrust laws to ensure nondiscriminatory treatment of independent distributors and access to an "assured" supply of electricity. But to divestiture deregulationists, promoting competition requires more drastic measures, in particular, the disintegration of generation and transmission functions.

Evaluating Divestiture Deregulation

Deregulationists include as part of their plans the separation in ownership of generation and transmission functions. They argue that transmission, unlike generation of electricity, will remain a natural monopoly. If multiple, independent generating firms were separated from numerous wholesale markets by a transmission monopolist, then an unregulated market would still provide few of the fruits of competition. The transmission system owner (who is also one among many generating firms) would effectively extract monopoly

[20]Most observers recognize long-term contractual sales as the primary form of transaction. However, a model, frequently called the "MIT model," relies instead on spot market sales in bulk power in which marginal-cost pricing principles are applied to bring generation on line at the lowest feasible cost. See Roger E. Bohn, Richard D. Tabors, Bennett W. Golub, and Fred C. Schweppe, "Deregulating the Electric Utility Industry," MIT Energy Laboratory Technical Report No. MIT-EL82-003 (January 1982).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

prices from its generation-level competitors. But divestiture of the transmission system would not, of itself, resolve the monopoly difficulty because an independent transmission company could also employ numerous tactics to force concessions from generating firms or wholesale customers. Therefore, according to these proposals, whoever owns the transmission grids (unless it is a government agency) must be severely constrained in service and price activities, treated generally as a common carrier. Since divestiture deregulationists see no significant cost saving attached to ownership of both generation and transmission assets, divestiture is a logical step, removing monopolistic enticements from all the generating-stage firms.

There are a number of attractive results suggested by divestiture deregulation. First, numerous independent generating firms could compete, and their sales of electricity would not require an onerous overlay of rate regulation as contractual (and possibly spot) wholesale market competition emerged. Continued rate regulation presently is seen as damaging to the financial stability of the utilities and their capability of meeting future consumer demands.[21] Second, direct costs of administering regulatory commissions could be reduced. Third, entrepreneurial behavior, motivated by an unrestricted profit function, would improve resource allocation efficiency. Last, greater technological innovation may result from a more competitive environment.

Unfortunately, deregulation-by-divestiture suffers from a number of serious deficiencies on its journey to greater competition.[22] When separated from generation ownership, the transmission system in most deregulation proposals plays a very powerful role in coordinating the operation and planning of the regional industry. These grids would span large geographic territories and provide much the same kinds of services that power pools now play; the transmission company would act as a means of horizontal integration for the industry. But detailed coordination among large integrated utilities today is frequently thwarted by self-interest conflicts among pool partici-

[21]See Paul W. MacAvoy, *The Regulated Industries and the Economy* (New York: Norton, 1979), chaps. 1 and 2.

[22]The severing of transmission system assets from the generation assets of currently integrated utilities presents a host of legal questions and would invariably cause a number of transitional costs. These important issues have been addressed elsewhere and are disregarded in the text discussion. See A. Joseph Dowd and John R. Burton, "Deregulation Is Not an Answer for Electric Utilities," *Public Utilities Fortnightly* 110 (September 1982): 21–8.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

pants,[23] and numerous independent generating companies may behave opportunistically as well. For example, the transmission grid coordinator in many proposals would assist in assuring that "adequate" capacity was available in its region. Detailed knowledge of existing and planned capacity would be requested of each generating firm. But some of these firms may perceive their self-interest to be served by exaggerating capacity plans in an effort to inhibit competitors' capacity expansion. Ironically, strong attempts by the transmission system coordinator to "rationalize" operations and planning among the independent generating firms (possibly supported by legal reporting requirements) would cut directly against the avowed purpose of the deregulation itself—to instill a competitive, entrepreneurial spirit in the generating segment of the industry.

If we assume that coordination among many generating units, across a large, complex transmission system is a cost-saving activity, then the industry may, without government interference, evolve into a more horizontally integrated structure. This possibility is noted as a source of cost savings by some deregulation supporters, but they reject horizontal integration because it also reduces the potential for desired wholesale competition. In fact, some proposals call for the breaking up of the generating plant holdings of larger utilities so that there will be a number of potential competitors. Although voluntary horizontal agreements could be used as a collusive, competition-foreclosing strategy, they also may produce more cost-effective means of organizing and planning than a transmission company's legally imposed planning regime.

A reduction in rate regulation is a purported benefit of divestiture deregulation, but this reduction may not occur. The problem of market power remains in sales by individual distribution systems;[24] therefore, rate regulation of private distributors' sales is included in all divestiture proposals. The newly formed independent transmission company (if a common carrier) must also be subjected to continual rate and quality-of-service review. Further, there is the possibility that the regulators at the retail level will not passively accept contractual energy purchases by the distributor as an uncontestable cost. For example, in a period of escalating electricity supply costs, similar

[23]Philip Fanara, Jr., James E. Suelflow, and Roman A. Draba, "Energy and Competition: The Saga of Electric Power," *The Antitrust Bulletin* (Spring 1980), p. 130.

[24]Divestiture proposals also present a problem in commission jurisdiction. The transmission system could be regulated by either the Federal Energy Regulatory Commission (FERC) or some newly formed regional regulatory system, with distribution systems remaining under state commission control. We can expect controlling commissions to resist efforts to curb their authority.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

to that experienced in the mid-1970s, local regulators may call into question the basis of distributor contracts with the generating firms. The political outcry by state commissions against "take or pay" natural gas contracts between producers and gas pipelines serves as a case in point. Divestiture deregulation schemes may not reduce the burden of direct economic regulation from the electricity industry, but rather may *compound* the transactions under continual commission appraisal.

Finally, after the disintegration of vertically integrated utilities is carried out, we are left to consider *how* the freestanding generating companies will compete. A large transmission system can encompass numerous plants, but many now are jointly owned by a mix of integrated private utilities and independent public and cooperative distribution systems, a trend viewed by some reformists as reducing the potential for wholesale competition.[25] New capacity would probably be made available only through contractual commitments for output over the life of a generating plant; this, of course, is a form of vertical integration. Without such promises, the industry currently finds the installation of new capacity very costly because of premiums required by potential investors for taking demand-side risks. If divestiture left untouched the existing contractual arrangements for capacity, then the bulk-power competition may occur only for long-term contracts on future capacity among few market participants.

Summing up, there are serious questions about the efficiency of competition among generating firms formed by divestiture deregulation and the degree to which the regulatory burden on the industry could be reduced. A practical view may seem to be that a little deregulation is better than none at all. However, in this industry a little deregulation may greatly increase regulatory complexity and reduce organizational efficiencies. One cannot consider a proposal that disallows competitors (and entrants) the use of efficient organizational forms as an enhancement of the competition process. A little deregulation could be worse than none at all.

Creating an Open Market in Electricity

It is helpful, at this point, to outline three salient features of competition in the electricity market. First, whoever controls transmission and distribution has considerable market power in the industry. This is due, given current technology, to the massive sunk cost commitment in user-specialized transmission and distribution assets that

[25]Fanara, Suelflow, and Draba, p. 138.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

must be made to compete. This condition provides a strong incentive for vertical integration. Today, virtually all privately owned utilities are vertically integrated. Direct competitors, at any given time, will be few. Thus, in an open market, direct competition generally would occur among *vertically integrated* firms.

Second, although market-transaction problems can be reduced by vertical integration (for the integrating parties), unless consumers are able to obtain ownership of the integrated system, they will remain susceptible to the integrated supplier's market power. Vertical integration backward from users, either by purchase of an existing utility's transmission and distribution lines or by addition of new capacity, may be an effective competitive strategy. Competitive pressures could be placed on existing suppliers through these entry threats. Rural electric cooperatives (outgrowths of the Rural Electrification Administration's mandate to extend electricity distribution in rural areas during the 1930s) provide examples of user-controlled organizations that frequently have organized jointly to acquire transmission and generation capacity. These generation and transmission ventures (G&Ts), owned and operated by member cooperatives, provide a substantial long-term source of power to member co-ops.[26]

Third, horizontal integration is currently extensive at the generation level through both ownership and pooling agreements. There may be cost advantages to further integration. In particular, the coordination of operations and planning may be facilitated by further voluntary horizontal integration.

Critics of electricity industry performance have identified economic regulation as the chief culprit in producing numerous ills (e.g., regulatory lag, resource misallocations, and loss of incentive to innovate). Nevertheless, regulation continues largely because of its supposed protection of consumers from suppliers' market power. But regulation is not the only feasible institutional form that may provide protection, nor is it voluntarily selected by those it is intended to shield. It may be that the costs of regulation are greater than the benefits so that a private organizational form would be a superior way to protect consumers. Testing this proposition, however, is not currently possible because private institutional options are not present. The following four suggestions would provide the missing market choices in the electricity industry:

[26]REA co-ops generated approximately 42 percent of their own power in 1982 and are briskly expanding that capacity. U.S. Department of Agriculture, Rural Electrification Administration, *44th Annual Report of Energy Purchased by REA Borrowers* (Washington, D.C.: Rural Electrification Administration, 1983).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

1. Remove all entry barriers to the generation, transmission, and distribution stages. Neither the granting of franchise to a single firm nor the selective granting of the power of eminent domain would be permitted.
2. Discontinue the use of antitrust and other policies as a means of forcing integrated electricity firms to "wheel" electricity.
3. Remove all subsidies and tax concessions to public power systems and cooperatives.
4. Provide each consumer with an option that when signed would release that individual's transactions with any electricity supplier from future regulatory control. Consumers also would be allowed to assign the "market-entry" options to utilities (or any other agent). Once an option is signed, by whoever has the assigned authority, reintroduction of rate regulation would not be permitted.

These policies would greatly alter the structure of incentives in the electricity industry. Consumers choosing to use their options would be exposed to market risks previously masked by economic regulation. These same consumers, however, would have considerable flexibility to search for a better deal than under economic regulation. The market risks are faced *only* when the option has been voluntarily exercised by a consumer. Each of the above points will be discussed briefly.

Entry Barriers

In contrast to reforms calling for competition only in the generation of electricity, our proposal is based on the assumption that all stages must be open to entry for a competitive process to proceed. Indeed, without achieving open entry across the board, it is likely that no form of competition will be particularly successful. If vertical integration is efficient, reducing transactions risks, then reforms that divest transmission systems from generation plants will increase costs. These reforms also place a heavy regulatory burden on the interface between the severed stages, because incentives still exist for the separate firms to perform as a vertical entity. The task of monitoring the behavior of these firms could be quite costly.

If entry is completely open, the decision to construct or purchase transmission and distribution system assets would be left in private hands. Enfranchisement in any form would not be used as a means of excluding or conditioning entry; all firms would have similar opportunities to serve any markets they care to enter. Although direct duplicative entry may be unusual, the possibility that new firms may

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

acquire existing assets acts to constrain integrated suppliers, especially in serving large-volume, dense markets.

Without the power of eminent domain, new transmission and distribution lines may be more costly to construct because of the numerous adjoining property rights that must be acquired. But it is not an impossible task. For example, the use of options contracts is a means of maintaining competitive pressure during negotiation. Removing eminent domain authority would lead to a market test of the value of the property rights, eliminating the implicit subsidy provided to any utility using it.[27]

Forced Access

The heart of most nondivestiture reforms of the electricity industry is the requirement that the owner of a transmission corridor provide "transport" (wheel) electricity across that corridor for outside parties. "Nondiscriminatory" access, based on marginal-cost pricing principles, may appear to move the industry past the bottleneck problem without causing inefficiencies in resource use. Mandated contract carriage has been proposed in other transport industries as the essential means of overcoming the bottleneck problem and increasing competition.[28]

There are a number of reasons to expect that the cost of forced access would not be low in the electricity industry. The major problem with wheeling is the dilution of control it implies: Resource allocation decisions may not be made on the basis of the highest expected value of service. The weaker transmission system ownership rights become, the closer wheeling proposals come to the complete loss of property rights under vertical divestiture. Further, oper-

[27]See Munch, p. 495. There is some evidence that the use of eminent domain distorts the cost of assembly and leads to an inefficient allocation of the subsidized activity. Another question of property rights concerns the ownership of existing distribution and transmission systems that have been built using eminent domain. Argument for contract carriage or forced wheeling of electricity may appeal to the notion that the ownership of delivery systems reflects, in part, the past application of coercive government powers to reallocate resources to the utilities. Whatever the merits of this assertion, there are problems with forced "sharing" of transmission systems; in particular, dilution of ownership control reduces the incentive to use the assets efficiently. It may be feasible, however, to devise means by which some portion of a transmission corridor's physical space (not existing assets placed in the corridors by the current supplier) could be taken from the owning utility and auctioned to private parties.

[28]In natural gas transport, a suggested solution ". . . is to provide open access to natural gas transportation facilities—to mandate contract carriage. The concept of contract carriage is simple. Natural gas transporters could be required to carry natural gas for others on a space-available basis." Nolan E. Clark and Glenn Willett Clark, "The Way to Deregulate Natural Gas," *Wall Street Journal*, 4 May 1983, p. 24.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ating a transmission system is a complex problem when physical and electrical characteristics across the entire system are interrelated. A capacity problem at one point of the system is a capacity problem across the system, unlike the cases of transport and pipeline technologies. Thus, the requirement to carry others' loads may reduce the reliability of the system. Finally, if access decisions were made or reviewed by political agencies, the efficiency sought by the economist-reformer would be balanced by numerous "equity" issues. It is likely that access would be based on legal formulations that only partly respond to economic issues. Opportunistic participants may use the mandated wheeling requirement as a means to cause misallocations in the existing delivery system and in the development of future delivery systems.

Subsidies and Taxes

The claim of investor-owned utilities that municipal and cooperative electric utilities compete unfairly is justified.[29] The development of an open market in electricity should proceed on the premise that all forms of ownership receive the same treatment with respect to access to federal energy, the cost of financing, and taxation. If cooperatives are an efficient organizational form, this must be demonstrated under the same conditions that private, investor-owned utilities face. All subsidies should be removed. In particular, the legally stipulated preference given to municipal and cooperative utilities in acquiring federally produced electricity should be eliminated, and market pricing of that electricity initiated.

Market Options

Individual consumers, whose suppliers are currently operating under franchise agreements (with transactions subject to state or federal price regulation), would receive market options.[30] When exercised, the option would release from further public utility regulation

[29]Both cooperative and nonfederal public systems enjoy advantages that the investor-owned utilities do not. The Rural Electrification Administration continues to guarantee loan rates below the cost of capital through the Federal Financing Bank. Municipal and state power authorities can also obtain financing below the cost to a private utility by issuing bonds with tax exemption on interest. Both cooperatives and nonfederal public systems are exempt from federal income tax and most state income taxes. All six federal power-producing agencies give preference to public utilities and cooperatives in the sale of electricity.

[30]This may be accomplished by state legislation, but, given the considerable role of FERC in economic regulation activities, federal law would be more effective. Federal legislation also would reduce problems of differential treatment of one utility serving customers in more than one state.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

all transactions for service between that particular consumer and any electricity supplier. Unsigned options could be assigned to any other party and reassigned without restriction. Information about exercised options would be a matter of public record. Once legally released from economic regulation, public utility commissions would have no further control over transactions—including pricing, service reliability, safety, and conditions of sale—involving that consumer. Instead, the relationship of buyer and seller would have to be reestablished contractually; new contracts formed would be enforced through the judicial system as any other private contract is.

Consumers and utilities may devise a number of ways to use options. For example, some consumers may decide to retain public utility regulation by holding the unsigned market options. Because these could later be signed, the consumers' supplier and the regulatory commission have an incentive to perform well, recognizing that a potential market threat exists to the regulatory regime. A regulated utility may desire the assurance of retaining commission regulation; thus, it may seek to acquire consumers' options and then hold them so that consumers would remain bound to the regulatory process. Such a supplier would still have the opportunity of later exercising the option if he finds regulation undesirable. A consumer also may decide to sell the rights to the options to an outside supplier or may assign them to an agent to be used in a manner specified by agreement.

The market option provides some attractive features. First, consumers can retain the customary institutional protection if they so desire; the option to end rate regulation does not have to be exercised. Second, the incentive to deregulate is neither legal coercion (such as divestiture or forced wheeling) nor subsidy. Instead, the difference in expected value of a market-determined allocation system over economic regulation is discoverable by individuals, and this net value is used to motivate the voluntary selection of institutional form. Resources that otherwise would be committed to market entry (e.g., construction of a competing distribution and transmission system) can be reduced. Further, the option (with positive value) increases the number of market participants searching for the private means to supplant rate regulation. Because the option value represents the opportunity cost of continued rate regulation, the device serves to enhance efficiency. We would have a market test of the value of rate regulation.

Whether the market-option system will greatly improve the consumer's position depends upon the asset value of the option. That value, in turn, depends upon the alternatives to public utility regulation that can be achieved in an open market. Note that the supplier

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

has no power to decide if market options are to be used, and entry into all phases of the industry would be allowed. Therefore, the value to the supplier of continuing with a regulatory commission may diminish if a relatively large number of consumers exercise their options for deregulation. This would occur if consumers selected other suppliers, or, as discussed below, formed user organizations to initiate market entry. The current supplier would then face the dilemma of negotiating with his current customers in anticipation of competitive threats, or ignoring the market options and rapidly losing his share of the market.

But if the supplier perceives no potential market threat, he would be unwilling to attempt to purchase the options or to bargain with customers. A consumer who similarly sees no realistic alternatives to his current supplier would be unwilling to release that supplier from commission regulation. In this case, public utility regulation continues, with one major difference: Consumers have agreed to accept the regulatory arrangement. They have accepted a "regulatory contract"[31] that did not exist previously. Although the regulated suppliers appear to be coerced into the regulatory arrangement, they do have the right to voluntarily bind themselves to the regulatory process by acquiring the options and not using them. In the latter case, the public utility commission would seem to represent both supplier and consumer, essentially arbitrating differences according to statute law and procedural requirements.

Unfortunately, the typical commission hardly operates as an arbitrator of two-party squabbles; instead, the commission is open to numerous other interest pressures, making a two-party conflict into a multiparty redistributional game. For the public utility commission to become an independent arbitration body, the "rules of the game" must be disassociated from the political arena and placed into contract law. Critical to this transformation is the voluntary surrendering of some authority to an arbitration agent by both supplier and consumer.

The change can occur, but not by deliberately attempting to modify the existing institutional arrangements of public utility law. Instead, the market-option concept may lead to private market institutions that have arbitration features. For example, many users, served by a single electricity supplier, may decide to forego public utility regulation and form long-term contracts with their supplier. The necessity

[31]Goldberg (1976) argues that economic regulation acts as an implicit, relational contract between consumer and commission (which then acts as the consumer's agent). This view does not seem consistent with the lack of individual consumer acceptance of a regulatory contract.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

of efficiently addressing contract difficulties across numerous and uncertain circumstances is a major reason for developing a mechanism to moderate such risks; the consumer may sensibly bargain for an arbitration body as a feature of any long-term contract. Because the costs of separate negotiations by many small users is great, user coalitions may form. A coalition's representative would have power to negotiate contracts, using the bundle of market options for all within the group. The exercising of the market options held by the group would be a necessary precondition for entering a new contract. A supplier may be willing to accept a contract with arbitration features to avoid the continuing hazards of public utility regulation. Thus, market options could act as an incentive to turn toward private institutions that will supplant many of the functions of the public utility regulation, while eliminating political intervention.

The packaging of market options by consumer coalitions may greatly reduce the costs of negotiating with a supplier. If the supplier perceives no likely alternative to his services, the power of the coalition may be weak, based only upon the perceived savings to the supplier of the private arrangement over public utility regulation. But a user coalition can do more: It may be possible for users to enter the market by vertically integrating backward, through the distribution and transmission system, to the generation stage. When the potential exists for an efficient entry of this kind, considerable pressure can be applied to a supplier. Such a user group, or cooperative, would function much like a club whose members share a public good—in this case, the reduced threat of market power resulting from joint action.[32] An integrated user cooperative is efficient to the extent that it can perform the function of reducing market-power threats better than alternative organizational forms. User organizations do not have to acquire physical assets to be useful in countering market power. The management of a user group (holding unsigned market options) would continually search for alternatives to the existing regulatory arrangements and would have the potential to engage another supplier or to enter the market itself. This posture can produce a significant threat to an existing supplier.

Consumers within such a cooperative generally would be similar in electricity-use characteristics. Heterogeneity would undoubtedly lead to dissention. For example, a large industrial user may strongly desire a time-of-day rate structure that may counter the interests of the typical household consumer. Such conflicts are resolved, in part,

[32]See Todd Sandler and John T. Tschirhart, "The Economic Theory of Clubs: An Evaluative Survey," *Journal of Economic Literature* 18 (December 1980): 1481–1521.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

by the exercising of one's right to enter (or not enter) any cooperative; more than one cooperative may operate within a given geographical area.

For a user cooperative that makes few asset acquisitions, outside funding may be unnecessary or very limited; entry should be relatively easy. But for the cooperative that attempts to integrate backward into the industry, a more difficult task of financing asset acquisition is presented. Obtaining funding by extending ownership is inadvisable because the organization's objective of reducing users' exposure to market power would be jeopardized. Clearly, only those who are users would share this objective. With ownership restricted only to users, the organization then is limited to debt financing, and the cost of capital may be much higher. Further, considerable asset-pricing risks are placed on the owner-consumer. Another difficulty is that the internal control of a cooperative may be especially difficult because an individual owner holds only a small share of the total ownership. Developing owner coalitions to challenge existing management of the cooperative may therefore be quite costly.

These and other difficulties associated with financing and operating a user cooperative decrease the value derived from backward vertical integration as a means of reducing the supplier's market power.[33] The aggressive backward integration of rural electric cooperatives (RECs) is suggestive of how private user cooperatives may perform in the future. However, because the RECs are highly subsidized, there is no assurance that truly private user-acquisition ventures would be efficient.[34] Fortunately, to be effective, it may not be necessary for a user cooperative to integrate far backward, if at all, in an open market. First, the cooperative holds the rights to an unregulated marketplace as a bargaining piece in negotiating supply contracts. That alone may make the asset value of a large collection of options quite substantial. Second, the market options could be used to entice an "outside" supplier to provide the transmission and dis-

[33]Richard B. Heflebower, *Cooperatives and Mutuals in the Market System* (Madison: University of Wisconsin Press, 1980), chaps. 1–3.

[34]The recent financial difficulties of the Washington Public Power Supply System, nicknamed "Whoops," suggest that the combination of financial subsidization and allegiance to a federal energy supply is no guarantee of success. In the early 1970s, with the backing of the Bonneville Power Administration, 138 participating utilities (mostly cooperatives and municipals) planned the addition of five nuclear reactors to supplement what was expected to be tight capacity in the coming decade. Only one of the plants may now be completed, with the rest being either shelved or scrapped. "Whoops" has over $2 billion of debt on which it will default. See David L. Shapiro, "Whoops and the Hodel Connection," *Wall Street Journal*, 20 May 1983, p. 24.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

tribution system linkages to a specific group of users.[35] Third, a user group may form that does nothing except hold the unsigned market options of its members. While retaining traditional regulatory protection, users hold open the possibility of eventual market entry.

No precise judgment can be made on what consumers would do; perhaps a number of different strategies would be employed. In all cases, the risks imposed on consumers using market options must be *voluntarily* accepted. But what of the consumers who do not wish to leave the regulated environment; does market entry weaken the feasible protection of the public utility institution? Although the answer to this question is "yes," a more important question is: Under what conditions should the relative merits of alternative institutions be debated? The true value of regulation cannot be known unless there are private (competing) alternatives. If opening these market alternatives reduces the value of public utility regulation, that loss represents a regulatory cost due to the absence of competition.

For example, with market entry allowed, utilities may find themselves negotiating lower prices with their nonregulated customers. These initially would be larger consumers, perhaps industrial firms that have considerable substitution opportunities among energy types or are cogenerators of electricity. The utility then may attempt to recoup its revenue losses by raising rates to regulated customers, providing these consumers with an additional incentive to opt out of the regulatory system. A similar process seems to be occurring in the telephone industry where long-distance telephone prices are not subject to direct rate regulation, but local telephone services are. Higher local access fees are likely to lead to "bypass" of local exchanges, especially by larger consumers.[36] Far from being undesirable, "bypass" reflects more accurately the opportunity cost of continuing with rate regulation, costs that can only be known if market alternatives are allowed.

In some ways the market-option plan for deregulating electric utilities is similar to the freedom allowed long-distance telecommunication carriers to develop market relations with consumers, and the freedom allowed consumers to initiate their own long-distance telecommunication programs. Market options could lead to new firms

[35]This strategy may be even more effective if the user cooperative first acquired the local distribution system for the users.

[36]Considerable political pressure can arise to halt the revenue leakage from bypass. For example, Senator Robert Packwood has introduced a bill that would place surcharges on any companies that bypass the local telephone exchanges. Undoubtedly, pressure for similar controls would occur as the option plan opened the electricity market to competition.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

selling electricity in competition with previously franchised utilities, and possibly some large electricity consumers (either industrial firms or residential/commercial cooperatives) providing for their own service by integrating backwards. The market-option scheme, unlike the partial deregulation in telephone service, can achieve *complete* industry deregulation. The option scheme seeks to avoid the kind of intense political pressures now being exerted on regulators of the remaining local, "natural monopoly" telephone exchanges. The deregulation of half of an interrelated industry provides the impetus for either the reregulation of the free half or the failure of the remaining regulatory institution. A market-option system is designed to avoid such difficulties for the electricity industry.[37]

Conclusion

Most recent deregulation proposals for the electric utility industry have focused on wholesale competition among independent generating firms. Many proposals are buttressed by suggestions to separate the transmission from the generation function, and place control of large, regional transmission systems under a single firm. The reforms would require a massive, legally coerced redistribution of ownership rights in the resources of the industry. A critical assumption behind these reforms is that forcing market transactions in lieu of intrafirm allocations will provide efficiency gains and stimulate competition.

We have questioned whether this view of competition is truly consistent with a real-world competitive process in electricity. There is a strong theoretical argument that the necessary preconditions for the kind of competition that would be attempted by reformists would not be voluntarily chosen by cost-minimizing firms. Given the transactional risks of market sales across highly specialized, durable transmission and distribution systems, vertical integration generally would be the most efficient organizational form. Given the probable gains of coordination in the operation and planning of transmission and generation systems, further horizontal integration also may be cost-efficient in the industry. If, in an open market, efficient firms would be highly integrated, denial of ownership rights across generation-transmission-distribution functions would retard the competitive process. Forced divestitures, rather than promoting competition, may provide the opposite effect by preventing efficient market entry.

[37]Although this paper has been limited to analysis of the electricity industry, the market-option concept could be usefully applied to a number of regulated industries undergoing partial deregulation. In particular, the regulation of local telephone service may be gradually eliminated by use of the option scheme.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The electricity industry often leaves the consumer with little short-term protection from the market power of his current supplier. This conclusion, however, does not necessarily require the continuance of economic regulation. This paper has suggested a reform for the industry that relies on the marketplace discovery of the means for protection and gain by individual participants. Ownership transfer or contract formation could be assisted by giving the consumer a market option—the right to opt out of rate regulation—which can be exercised directly or assigned to another party. The use of these options in an open market would provide a realistic test of the value of public utility regulation in the electricity industry. Those who wish no major changes in the industry would make deregulationists prove their assertions of efficiency gains. This paper has suggested the means by which such evidence could be acquired.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

INFORMATION: A NEGLECTED ASPECT OF THE THEORY OF PRICE REGULATION

E. C. Pasour, Jr.

Introduction

Despite the fact that in the United States prices are now being regulated in competitive as well as noncompetitive industries, there is an increasing consensus that price regulation is not achieving its stated purpose. Paul MacAvoy, for example, found that during the inflationary conditions of the 1970s, price regulation reduced profitability in the electric utility and other industries "to levels below those required to sustain the quality and growth of service."[1] The dissatisfaction with current price regulation cuts across the ideological spectrum. Yet, there is no consensus about *why* government intervention is failing to achieve its stated purpose, which is (at least in the area of "natural monopolies") to ensure that price is based on production costs.

Ralph Nader and consumer groups tend to fault the leadership of the regulatory agencies. Economists in the public-choice tradition stress "political failure," that is, shortcomings innate in the political process.[2] Ronald Coase attributes the poor performance of economic regulation not only to political failure but also to the failure of economists to solve the problems involved in economic regulation.[3]

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at North Carolina State University, Raleigh, N.C. 27650.

[1]Paul W. MacAvoy, *The Regulated Industries and the Economy* (New York: W.W. Norton and Co., 1979), p. 79.

[2]James M. Buchanan et al., *The Economics of Politics* (London: Institute of Economic Affairs, 1978); Alan Peacock, "On the Anatomy of Collective Failure," *Public Finance* 35 (1980): 33–43.

[3]Ronald H. Coase, "Comment," in *The Crisis of the Regulatory Commissions*, ed. Paul W. MacAvoy (New York: W.W. Norton and Co., 1970), pp. 53–56.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

MacAvoy suggests that the "critical step toward improving the present condition of the regulated industries would be to develop better administrative processes" in the regulatory agencies.[4] Our study suggests another reason for the shortcomings of regulation. Proposals to set prices on the basis of marginal costs assume away informational problems and fail to recognize the importance of the market as a discovery process.[5] Regulators cannot satisfactorily set prices because there is no way to obtain the necessary data. Current regulation and reform proposals tend to view government regulation as an alternative to the market in discovering competitive costs and prices. The competitive process, however, cannot be simulated and competitive costs and prices can only be determined by *having competition.*

Prices of electricity, telephones, and other public utilities have long been regulated where it is assumed that there is an absence of competitive sources of supply. Although the relative merits of marginal-cost versus average-cost pricing have been widely debated in the case of natural monopolies, there is little recognition that regulators cannot obtain data on cost as it motivates choice. Even under the competitive conditions of agriculture, product price supports are now based on production costs. Although practical problems of measuring cost have been widely discussed, economists have largely failed to point out why cost is theoretically indefensible as a basis for setting price supports.[6]

The outline of this paper is as follows. The nature of cost as it influences entrepreneurial choice and the implications for measuring cost are first discussed. The theoretical problems of basing price on cost under competitive conditions and the implications of information problems associated with price regulation in the case of natural monopoly are described. Marginal cost pricing, a widely discussed method of price regulation, is then analyzed in terms of its informational requirements.

Subjectivity of Cost

Opportunity cost represents the value of opportunities foregone by the decision maker as a result of selecting a particular course of action. The cost of a vacation trip, for example, is the value attached

[4]MacAvoy, *Regulated Industries,* p. 122.

[5]I.M. Kirzner, *The Perils of Regulation: A Market-Process Approach* (Coral Gables, Fla.: Law and Economics Center, 1978); I.M. Kirzner, *Perception, Opportunity and Profit* (Chicago: University of Chicago Press, 1979).

[6]E.C. Pasour, Jr., "Cost of Production: A Defensible Basis for Agricultural Price Supports?" *American Journal of Agricultural Economics* 62 (May 1980): 244–48.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

by the decision maker to the boat or automobile which cannot be purchased if the trip is taken. Thus, opportunity cost stresses the relationship between the act of choice by the decision maker and the value of the perceived opportunities foregone. Since the opportunities foregone are not actually experienced, cost as it influences choice involves an ex ante evaluation by the entrepreneur of uncertain future outcomes.[7] More than 40 years ago, Coase indicated why the evaluation of profit opportunities will vary depending upon the entrepreneur's attitude toward risk and subjective assessment of the future:

> Consider now a businessman trying to decide between alternative courses of action, each of which might produce so many different results. It is clear that the choice will depend partially on the attitude to risk-taking of the person deciding. Some businessmen will be influenced much more by possibilities of high profits which are not very probable than will others. There is no one decision which can be considered to maximize profits independently of the attitude of risk-taking of the business man.[8]

The ex ante planning process, and consequently cost, inevitably involves subjective entrepreneurial judgments about the future. Subjectivity enters cost calculations for inputs owned and rented by the firm as well as when placing a value on the entrepreneur's own time. Consider the commonly used procedure in estimating product cost by adding together the market prices of resources used in the production process. Summing up outlays incurred in this manner is not likely to provide the relevant choice-influencing cost that affects entrepreneurial activity even in the case of nonspecialized inputs. Opportunity costs to the decision maker continue to fluctuate with price movements in the market even in the case of inputs already purchased.[9] This problem of lack of identification between the price of purchased inputs and opportunity costs is, of course, much more serious during periods of rapidly rising prices and economic change. Market outlays are generally equal to opportunity costs for nonspecialized resources, but only under highly restrictive equilibrium conditions.[10]

[7]James M. Buchanan, *Cost and Choice* (Chicago: Markham Publishing Company, 1969); E.C. Pasour, Jr., "Cost and Choice—Austrian vs. Conventional Views," *Journal of Libertarian Studies* 2 (Winter 1978): 327–36; K.I. Vaughn, "Does It Matter That Costs Are Subjective?" *Southern Economic Journal* 46 (January 1980): 702–15.

[8]R.H. Coase, "Business Organization and the Accountant," pp. 95–132, in *L.S.E. Essays on Cost*, eds. J.M. Buchanan and G.F. Thirlby (London: Weidenfeld and Nicolson, 1973), p. 104.

[9]Ibid, p. 111.

[10]Buchanan, *Cost and Choice*.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Subjective considerations on the part of the entrepreneur are also inevitable and even more important in determining the overhead costs of machinery and other capital equipment. The relevant depreciation cost (including obsolescence) hinges on the unknown future and, consequently, expectations are crucial in the estimation of interest and depreciation costs. Estimates of interest and depreciation costs must be based on historical "cost" records of the business firm or on expectations of future conditions. Since the relevant cost estimates are necessarily expectations rooted in uncertainty, overhead cost estimates by outside observers may vary widely from the opportunity costs perceived by the entrepreneur.

The use of objective cost estimates can be useful to the decision maker. There is no reason, however, to expect objective cost estimates by external observers to correspond to the costs relevant to the act of choice by a particular decision maker.[11] The inability of outside observers to objectively estimate cost as it influences entrepreneurial choice means that conventional regulation cannot achieve its stated objective. While regulators can affect profitability by varying price, they cannot effectively set price on the basis of marginal-cost calculations. To understand why, consider the informational problems inherent in governmental attempts to regulate price under competitive conditions as well as natural monopoly.

Marginal-Cost Pricing under Competition

In a world of nonspecialized resources, a change in demand has no effect on production cost and cost can be defined independently of product demand. In the real world, however, land, labor, productive facilities, and entrepreneurship are specialized to the firm in the sense that the resources of any particular firm cannot be precisely duplicated.[12] If one firm owns a superior input (e.g., unusually productive land), the return to the superior input is capitalized into higher resource prices. Competition bids up the price of specialized resources so that firms with superior resources face production outlays similar to those of other firms with less-productive resources. An increase in product demand which increases the expected product price will increase returns to specialized resources and, consequently, resource outlays. Thus, when production conditions involve specialized resources, cost of production cannot be defined independently of demand. Moreover, under these conditions the best

[11]G.L.S. Shackle, *Epistemics and Economics: A Critique of Economic Doctrines* (London: Cambridge University Press, 1972).

[12]Milton Friedman, *Price Theory* (Chicago: Aldine Publishing Co., 1976), p. 147.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

estimate of production cost is product price. Competition brings about an increase in marginal costs so that production outlays on a per-unit basis will tend to be equal to the expected product price. Any observed difference between production outlays and product price may be taken only as an indication of the efficiency of the capital market in revaluing assets.[13]

Consider the tobacco price support program, which is a government-sanctioned cartel that restricts production through acreage or poundage allotments to individual producers. When product price is supported by the government above the market-clearing price, the right to produce acquires a value, namely, the allotment value. Thus, the tobacco cartel raises production costs because the cost of the allotment is an opportunity cost to the individual producer. This phenomenon of program benefits being capitalized into input prices has been characterized by Gordon Tullock as the "transitional gains trap." When such programs are initiated, land prices increase and owners of land receive a windfall gain.[14] In the case of the tobacco program and other agricultural cartels, many current producers purchased production rights (allotments) after the program was initiated and, hence, did not receive the initial gain. Once begun, there is no way to avoid the trap, i.e., to terminate a government subsidy program without imposing losses on program participants.

Moreover, as long as some inputs are less than perfectly elastic in supply, there is no way to avoid this ratchet effect in which a mandated increase in product price leads to an increase in production outlays. Yet, economists in land-grant colleges throughout the United States and in the Department of Agriculture are devoting countless man-days to empirical estimates of production costs as a basis for determining the level of agricultural price supports.

When politics creates profit opportunities (as in the case of agricultural price supports), investment will take the form of attempts to secure access to the profits. Moreover, "rent-seeking" behavior is not restricted to competitive industries. Richard Posner contends that obtaining and maintaining a monopoly privilege is itself a competitive activity, and that, at the margin, the costs of obtaining the governmental privilege are equal to the benefits. Thus, the "transitional gains trap" theory is applicable to noncompetitive as well as competitive industries.[15]

[13]Ibid, p. 146.

[14]Gordon Tullock, "The Transitional Gains Trap," *The Bell Journal of Economics* 6 (Autumn 1975): 671–78.

[15]Richard A. Posner, "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* 83 (August 1975): 807–27.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

In the case of public utilities (natural monopolies), for example, the objective of regulation presumably is not to increase price but to prevent monopoly pricing by setting a maximum price at the competitive level. As the following discussion demonstrates, however, informational problems in setting price on the basis of cost are no less demanding in this case than for the competitive conditions described above.

Price Regulation of the Natural Monopoly

There has been a great deal of discussion concerning efficient resource use in "decreasing cost" industries where economies of scale cause average costs to decrease throughout the relevant range of production. If price were set equal to marginal cost in this case, the firm's outlays would exceed the receipts and the firm would incur a loss. Many economists have argued the merits of administered marginal-cost pricing coupled with a subsidy to prevent losses to the firm. An alternative is to set price equal to average cost so that no subsidy is required. Coase summarizes the problems with much of the literature dealing with the advantages of marginal-cost pricing:

> As I see it, the argument for marginal cost pricing, like many propositions in modern welfare economics, is more concerned with diagrams on a blackboard than with the real effects of such policies on the working of the economic system. I have referred to this type of economics as 'blackboard economics' because, although factors are moved around and prices are changed, and some people are taxed and others subsidized, the whole process is one which takes place on the blackboard. This is not the way in which one operates with a social system.[16]

The "blackboard economics" nature of analyses relating to the relative merits of marginal versus average cost pricing has received little attention in the literature on economic regulation. The discussion of marginal-cost pricing typically proceeds as if the relevant data concerning costs and returns are *given* to the entrepreneur as well as to the outside observer (or regulator). As Kirzner has aptly pointed out, however, if one assumes that the problem is one of allocating given means among given ends, the entrepreneurial element has been assumed away.[17] If the means and ends are given, profit maximization becomes wholly computational and there is no room for

[16]R.H. Coase, "The Theory of Public Utility Pricing and Its Application," *The Bell Journal of Economics* 1 (Spring 1970):119.

[17]I.M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

entrepreneurial activity. If this point—that marginal-cost pricing merely assumes that data are available—appears unimportant, consider the following discussion of the principles of public-utility regulation by Abba Lerner:

> [T]he case where marginal cost is above average cost is an *easy case*. . . . It is not too difficult to get the capitalist to charge a price equal to marginal cost and to keep the excess of this price over average cost. . . . But where marginal cost is below average cost . . . the right public utility price can be established only if the government steps in and takes the negative rent which nobody else wants.[18]

In this discussion, there is an implicit assumption that data on costs and demand are either given to the regulator or that the regulatory agency can readily obtain these data. It is implied that the hard problem is a political one of implementing marginal-cost pricing. What is the reality? Can regulatory agencies obtain the data required to set price on the basis of marginal cost? Thirlby summarizes the problems confronting a regulatory agency (or other outside observer) in monitoring the extent to which a seller is equating marginal cost and price:

> When it is understood that a reckoning of cost . . . depends upon the forecasting of events and outcomes of the future, and when it is understood that any individual is uniquely situated in relation to past events on which such forecasts are based, it becomes clear that the results of the reckoning is dependent for what it is upon the unique knowledge and attitude (towards uncertainty and risk) of the unique and uniquely situated individual who calculates it. . . . The cost (as well as the revenue) calculation, or residual elements in it, is ultimately a matter of subjective opinion. . . .[19]

When the subjective nature of the decision-making process is realized, it becomes clear that no method of cost accounting can reproduce on paper the mental processes of an entrepreneur. Thus, there seems to be no reason to think that regulators will ever be able to monitor the extent to which various pricing rules are followed.

Despite the subjective nature of costs and the uncertainty concerning demand, informational problems associated with cost and demand estimation are neglected or minimized in proposals to regulate price. Marginal-cost pricing, for example, assumes that the regulator has information on demand and cost conditions. From the standpoint of cost, however, it is not a question of a public utility

[18]A.P. Lerner, "Conflicting Principles of Public Utility Rate Regulation," in *The Crisis of the Regulatory Commissions*, pp. 25–26.

[19]G.F. Thirlby, "Economists' Cost Rules and Equilibrium Theory," in *L.S.E. Essays on Cost*, pp. 280–81.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

discovering the relation between price and output. The real world never contains an actual entity corresponding to the marginal-cost curve, and the amount of output a firm will attempt to produce at any given price depends upon a number of factors including the time horizon, expected input prices, technology, expected environmental controls, and expected taxation policies.

The problem of determining the demand curve facing the utility is no less difficult. As in the case of cost, demand cannot be accurately described as the relation between price and the quantity taken of a given commodity. The amount of product which buyers will purchase per unit of time at any price also depends upon a number of factors including consumer income, length of adjustment period, prices of substitutes and complements, and expected product improvements. Thus, the real world never contains an actual entity corresponding to the demand curve for potatoes, electric power, or any other product.[20] Furthermore, demand conditions are not given to the firm; they have to be discovered by trial and error.

The heroic nature of the assumption that the demand curve is known becomes clear when actual empirical estimates of demand are analyzed, and it is found that demand estimates vary widely due to such factors as the econometric procedures used and the time horizon or length of run that is chosen. A recent study by Resources for the Future, for example, reviewed the literature concerning the estimates of price elasticities of energy demand. The findings were that statistical research

> may only confuse the decision maker. For any given consuming group, one can find a range of statistical results wide enough to support virtually any predisposition about the importance of the price effect. Statistical estimates of the price elasticity of demand . . . are close to zero in some studies and very large in others. These measures also vary by product, by consuming group, by region, by season, and by time period.[21]

What are the implications of the preceding analysis for price regulation? Proposals to improve public-utility regulation place little emphasis on informational problems. MacAvoy, as previously mentioned, cites better administrative processes as the critical step in improving price regulation. Specifically, in his 1979 study he identifies the use of past-period estimates of costs to establish future

[20]Leland B. Yeager, "Methodenstrait over Demand Curves," *Journal of Political Economy* 68 (February 1960): 53–64.

[21]Douglas R. Bohi, "Price Elasticities of Energy Demand: An Introduction," *Resources*, no. 65 (Summer 1980), p. 11.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

revenues as a major problem and recommends "profit constraints based on current and future costs of investments for providing service" (p. 122). Since cost involves an ex ante appraisal of uncertain future outcomes, however, there seems little reason to expect that the regulator's estimate of choice-influencing cost will correspond to, or even closely approximate, that of the decision maker. What, for example, is the cost of generating electricity by nuclear power? What is the likely length of delay in approval of plant construction? What is the probability that a plant once in operation will be closed temporarily or permanently? These and numerous other factors will have a critical influence on cost. Yet, since the answer to these questions will only be revealed by the passage of time, there is no reason to expect the regulator and the regulated firm to answer these and similar questions in the same way.

There is also the problem that costs to the firm would be different if the constraints within which the firm operates were different. Arzak and Edwards seek to explain why "internal inefficiency" may exist in regulated or unregulated firms. They cite "X-inefficiency" and "managerial discretion" as reasons for "the failure to optimize the rate and direction of technological change."[22] To be meaningful from the standpoint of entrepreneurial choice, however, efficiency must pertain to the entrepreneur's information and his goals. The costs and returns of acquiring various kinds and amounts of technological information vary widely from firm to firm depending upon such factors as size, age of present capital assets, and experience of managers. Thus, there is no reason to expect that the optimal amount of technological information should be the same for every firm. Consequently, there is no known way to identify X-inefficiency or to demonstrate empirically that the operation of a firm is inefficient on the basis of the costs and returns that motivate entrepreneurial choice.

In recent years, there has been renewed interest in the use of competitive principles in utility regulation. Harold Demsetz suggests franchise bidding as an alternative to conventional rate-of-return methods of controlling natural monopolies. He contends that competition at the stage of awarding the franchise would be sufficient to achieve competitive pricing even though increasing returns to scale might dictate that only one firm provide the service.[23] After

[22]Enrique R. Arzak and F.R. Edwards, "Efficiency in Regulated and Unregulated Firms: An Iconoclastic View of the Averch-Johnson Thesis," in *Problems in Public Utility Economics and Regulation*, ed. Michael A. Crew (Lexington, Mass.: D.C. Heath and Co., 1979), p. 45.

[23]Harold Demsetz, "Why Regulate Utilities?" *Journal of Law and Economics* 11 (April 1968): 55–65.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

exploring problems associated with awarding and monitoring franchise agreements, Williamson and Goldberg conclude that the Demsetz approach may not be superior to the conventional rate-of-return method of regulation.[24]

Implications and Conclusions

Shortcomings of the rate-of-return approach to price regulation have long been recognized, and there is a near consensus that price regulation is not achieving its stated purpose. There are two main problems. First, conventional methods of regulation assume that regulators can obtain information upon which entrepreneurial decisions are based. However, as suggested above, there is no known way for the regulator to measure the costs and returns that motivate entrepreneurial choice. These problems are no less important in competitive markets than in the case of natural monopoly. Furthermore, as Kirzner suggests, knowledge of least-cost methods of production can be discovered only through the competitive process, and regulators are unable to simulate the entrepreneurial discovery process of the market:

> How do government officials know what prices to set (or qualities to require, and so forth)? Or, to press the point further: How will government officials know if their earlier decisions were in error, and in what direction to make corrections? In other words, how will government officials *discover* those opportunities for improving the allocation of resources, which one cannot assume to be automatically known to them at the outset of a regulatory endeavor? . . . There is no entrepreneurial process at work, and there is no proxy for entrepreneurial profit or loss that might easily indicate where errors have been made and how they should be corrected.[25]

A second problem is that regulation not only distorts the discovery process of the market, it also creates new profit opportunities for regulators as well as for regulated firms. Even if the regulator could obtain the information required to implement marginal efficiency rules, he does not have the incentive to efficiently utilize the information. Regulators are not motivated to minimize cost since they will not personally reap the rewards. There is an implicit assumption in much of the discussion related to optimal pricing rules that regu-

[24]Oliver E. Williamson, "Franchise Bidding for Natural Monopolies: In General and with Respect to CATV," *Bell Journal of Economics* 7 (Spring 1976): 73–104; Victor E. Goldberg, "Competitive Bidding and the Production of Pre-Contract Information," *Bell Journal of Economics* 8 (Spring 1977): 250–61.

[25]I.M. Kirzner, *The Perils of Regulation*, pp. 15–16.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

lators act solely to maximize social efficiency without regard to their own self-interest. The evidence, however, suggests that self-interest is no less important for regulators than for decision makers in the private sector.[26]

In evaluating policy alternatives, information problems and problems of program implementation are too often ignored or minimized.[27] Blackboard analyses of the relative merits of marginal-cost versus average-cost pricing provide little useful information in economic regulation. As Hayek stressed a generation ago, the marginal efficiency rules of theoretical welfare economics do not provide the solutions to the economic problem which society faces:

> The reason for this is that the 'data' from which the economic calculus starts are never for the whole society 'given' to a single mind which could work out the implications and can never be so given. . . . The economic problem of society is thus not merely a problem of how to allocate 'given' resources—if 'given' is taken to mean given to a single mind which deliberately solves the problem set by these 'data.' It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know.[28]

The carefree use of marginal efficiency rules may be attributed to the assumption of perfect knowledge in neoclassical price theory. The presumption of perfect knowledge assumes away the central task of economic theory, which is to account "for the way information is brought to bear on the decisions of market participants and on the extent to which the market directs relevant information to those who can make the (socially) best use of it."[29] The social fragmentation of knowledge and the best way to utilize existing knowledge was a central feature of the Lange-Mises-Hayek economic calculation debate of a generation ago.

Proposals to replace the process of competition by planned pricing systems are subject to the informational problems that Hayek stressed. The fact that there are sizeable economies of scale or that production does not conform with the standards of the model of perfect competition does not imply that government intervention is warranted. The

[26]J.M. Buchanan et al., *The Economics of Politics*; Alan Peacock, "On the Anatomy of Collective Failure."

[27]Charles Wolf, Jr., "A Theory of Nonmarket Failure: Framework for Implementation Analysis," *Journal of Law and Economics* 22 (April 1979): 107–39.

[28]F.A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), pp. 77–78.

[29]I.M. Kirzner, *Perception, Opportunity and Profit*, p. 32.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

relevant question is whether price regulation or unregulated markets can make the best use of existing and decentralized knowledge.

In light of the problems associated with informational and political failure, it should not be surprising when economic studies find regulation to be ineffective or counterproductive. Stigler and Friedland, for example, were unable to find that the regulation of electrical utilities had any significant effect on utility rates.[30] In a follow-up study, Gregg Jarrell concluded that state regulation of the electric utility industry actually brought about *higher* prices and profits.[31] As previously indicated, MacAvoy found that regulation has recently reduced profitability and quantity of output. Thus, as Gary Becker suggests, it may be preferable even in the case of public utilities not to regulate rather than to regulate and suffer the effects of political imperfections.[32]

A necessary first step in evaluating the potential for economic regulation is to understand why regulators cannot obtain the data which motivates entrepreneurial choice. Even if political failure were no problem, there is no way for regulators to obtain the data required to set prices on the basis of marginal efficiency rules. The entrepreneur is given data on neither ends nor means, and if these data were given, the entrepreneurial role would become trivial. Moreover, since choice is necessarily among imagined alternatives, "choice-making under certainty becomes internally contradictory."[33] More attention to the informational problems inherent in all economic regulation by the state appears long overdue.

The assumption that economic regulation is required for industries with substantial economies of scale also warrants more attention. Can government promote competition more effectively in such cases by maintaining freedom of entry or by price setting and restricting competition? Competition can arise not only from other producers of the same product but also from new products. Consequently, abolishing the statutory monopoly enjoyed by public utilities to permit freedom of entry may be a more effective means of increasing

[30]George J. Stigler and C. Friedland, "What Can Regulators Regulate?" *Journal of Law and Economics* 5 (October 1962): 1–16.

[31]Gregg A. Jarrell, "The Demand for State Regulation of the Electric Utility Industry," *Journal of Law and Economics* 21 (October 1978): 269–96.

[32]Gary S. Becker, "Competition and Democracy," *Journal of Law and Economics* 1 (October 1958): 105–9.

[33]James M. Buchanan, *What Should Economists Do?* (Indianapolis: Liberty Press, 1979), p. 281.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

competition than attempts to modify or "fine-tune" current methods of regulation.[34]

Finally, government intervention to regulate price should be evaluated in terms of a principled approach rather than on case-by-case opportunism based on notions of Pareto optimality. Each proposed intervention to regulate price should be appraised for its repercussions on the system as a whole—for its anticipated "legal, political, social, and ethical repercussions."[35] Economic theory can help show us why the apparent merits of a specific intervention are not the only relevant considerations and why it is that ". . . when we decide each issue solely on what appear to be its individual merit, we always over-estimate the advantages of central direction."[36] Yeager makes a persuasive case for a principled approach to economic policy:

> If we avoid appraising and comparing alternative economic systems as wholes, if we avoid forming and acting on a coherent conception of the good society, we shall make momentous choices in ignorance and by default. The opposite approach, respecting principles, would go far . . . toward reinstating the wisdom of the Founding Fathers regarding the scope and power of government.[37]

His conclusion seems equally applicable for price regulation.

[34]S.C. Littlechild, *The Fallacy of the Mixed Economy* (London: Institute of Economic Affairs, 1978).

[35]Leland B. Yeager, "Economics and Principles," *Southern Economic Journal* 42 (April 1976): 569.

[36]F.A. Hayek, *Rules and Order*, vol. 1 of *Law, Legislation and Liberty* (Chicago: University of Chicago Press, 1973), p. 57.

[37]Yeager, "Economics and Principles," p. 569–70.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

COMMUNICATIONS

PRIVATIZATION, JUSTICE AND MARKETS

Richard Auster

As the gains from privatization necessarily increase with the density of usage of the commons, it is quite natural that we find the movement to privatize public land holdings emerging. Privatization is both natural and correct and it is in no way the purpose of this paper to argue against it. Private ownership is clearly a more efficient method of controlling the usage of our now public lands. Efficiency is not the only issue, however. There is also the issue of equity, of preventing injustice and theft. That is, since governments are simply service firms which are publicly held in democracies,[1] there is the issue of selling assets for what they are truly worth and not in effect giving them away. The recent suggestion by Professor Hanke (1982) that we sell all the rangeland in the West to the ranchers who now hold Bureau of Land Management (BLM) leases for something under $19 per acre is in effect giving the land away.

Hanke would have us believe that because the "custom" has arisen of linking BLM grazing rights to particular parcels of private land, the ranchers who own these private parcels have either implicitly or explicitly paid for all of the value the BLM land represents, save that sum which is the present discounted value of the grazing fees they are required to pay. Hanke, claiming we should not steal from them, argues that it naturally follows that we must first offer the ranchers the right to buy the land in fee simple at the present discounted value of those fees, a sum which averages out to slightly under $19 per acre! This is wrong; let us see why.

It must be remembered that value in exchange is derived from value in use. Since the only use permitted the ranchers under their current leases is that of grazing, the full value of the public tracts cannot have been incorporated into the market values of their private

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Associate Professor of Economics at the University of Arizona, Tucson, Ariz. 85721.

[1]Governments are like widely held corporations with all the problems attendant on that form of doing business. See Auster and Silver (1979).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

holdings. Only the value of the use of the land for grazing could have been capitalized; not the mineral rights, timber rights, or rights to subdivide and develop. What has been capitalized, even if it is the full value of the BLM grazing rights net of the lease fees, can only be a small fraction of the total value of these lands when held in fee simple. This point becomes particularly important when we contemplate the continued shift of population from the East to the West. At $19 per acre we are contemplating one of the biggest giveaways in a long history of such misguided government transfers.

Actually, it is impossible that even the full value of the grazing rights have been capitalized into the values of the ranches. The full capitalization of the grazing rights into the value of the private holdings would have taken place only if there were certainty about the future status of these rights. Since they had never been granted in law, this is most unlikely. Moreover, full capitalization assumes that the market for these holdings was in perfect equilibrium, which is exceptionally unlikely given the dramatic population shifts that have been occurring, the imperfections in capital markets, and the lumpiness of the transacted quantities. I think the issue of the presumed certainty of their continued exclusivity with respect to the BLM grazing rights is the key defect of this aspect of the Hanke plan. The exclusivity of these lease rights—that is, their failure to be open to all in a process of public bidding—is only a relatively recent phenomenon, an administrative oversight as it were. While it is certainly politically smart to buy out a most organized part of the opposition, in this case the ranchers, we must wonder at the implicit encouragement such a policy of compensation would give to future squatting on the public domain. Moreover, once we begin to recognize what are in a sense usufructuary rights to the public domain and the consequent need to compensate losers from its privatization, we are opening up a large can of worms.

Much of the same reasoning that Hanke applies to the rights of the ranchers applies with equal, if not more, strength to the implicit rights of the public workers whose functions I (and Professor Hanke, I understand) wish to privatize as well. Since in many instances their jobs were covered by civil service tenure rules, it would seem that their claims would be stronger. Will we need to compensate them as well? Perhaps we should think this through before we leap.[2]

[2]Actually, I have at times argued that we should compensate public workers whose functions are privatized. See Auster (1982). For example, we could give the postal workers the plant and equipment of the U.S. Postal Service in return for the elimination of their monopoly privileges. The political finesse of such a procedure is appealing, but the area needs a lot more debate.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Ultimately what is wrong with the Hanke proposal is that inadvertently he has fallen into the planner's trap of believing that markets might be dispensed with and prices calculated at the center. What we need to do is to rely on markets. The public lands should be put up for auction as Professor Smith (1982) suggests. If we really believe, and I must confess to agnosticism on this point, that the ranchers have by now acquired a right to use the BLM land for grazing through *usus,* then we should grant them deeds to that effect and auction off the other rights to the land. The allocation of the rights to the commonly owned lands by competitive auction is in the true spirit of modern economics.[3] Professor Hanke seems to have forgotten his own criticisms of central planning. He now seems vaguely like those socialists who in the great "calculation of prices under central planning" debates proposed that a collectivist economy could solve its price calculation problem by using the prices revealed by the free markets in capitalist countries.

Markets, however, are processes which are situation and time specific. The answers of one market (price, quantity, quality) will not hold for others or for it at other times and situations. There is no perfect substitute for an actual market. Even if privatization is desirable, which it is, how one gets there is important.

References

Auster, R. D. "1982 Public Choice in the Streets: The Libertarian Campaign in Arizona District 5." University of Arizona, 1984. (Mimeographed.)

Auster, R. D., and Silver, M. "The State as a Firm, Economic Forces in Political Development." In *Studies in Public Choice,* No. 3. Boston and The Hague: Martinus Nijhoff, 1979.

Hanke, Steve H. "The Privatization Debate: An Insider's View." *Cato Journal* 2 (Winter 1982): 653–62.

Smith, Vernon L. "On Divestiture and the Creation of Property Rights in Public Lands." *Cato Journal* 2 (Winter 1982): 663–85.

[3]Having just praised my colleague Professor Smith's paper, perhaps in closing I can point out a problem with it as well. This problem arises because of the imperfection of existing capital markets, which I take as a fact. Given this, it will not be equitable to auction off the rights even if they are initially allocated as he suggests, although that will go a long way in that direction. The Dorn suggestion (p. 675, n. 19) if coupled with the government carrying back the bid amounts to all citizens at the same interest rate would, I believe, complete the equity picture.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"PRIVATIZATION, JUSTICE AND MARKETS": A REPLY

Steve H. Hanke

Before dealing with the central issue raised by Professor Auster, several assertions contained in his comment must be addressed, since they are either in error or misleading.[1]

First, Professor Auster claims that I propose to sell all the public lands for an average price of slightly under $19 per acre. This assertion is incorrect.

To illustrate the method for computing a first-refusal price for public grazing lands, I use data from a single 1,500-acre parcel of Bureau of Land Management land.[2] Contrary to Professor Auster's claim, I do not propose to use the first-refusal price for this one parcel as a price for all federal grazing lands. In fact, I clearly state that first-refusal prices should be calculated separately for each lease that is privatized.

Second, Professor Auster asserts that under my privatization proposal ranchers would obtain, in addition to "surface rights," both timber and mineral rights. This assertion is incorrect.

In my article, I only address issues that are associated with President Reagan's program to privatize some of the public lands. This program does not include the sale of any mineral rights. Moreover, my article is further limited, since it only addresses the issues associated with the sale of "surface rights" on public grazing lands. It

---

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is Professor of Applied Economics at The Johns Hopkins University, Baltimore, Md. 21218. He also serves as a Senior Economic Adviser to the Joint Economic Committee of the U.S. Congress, and is a Senior Fellow at the Manhattan Institute for Policy Research in New York City.

[1]R. D. Auster, "Privatization, Justice and Markets," *Cato Journal* 3 (Winter 1983/84): 869–71.

[2]Steve H. Hanke, "The Privatization Debate: An Insider's View," *Cato Journal* 2 (Winter 1982): 653–62.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

does not address the problems associated with the sale of other assets contained in the president's program, such as lands that contain timber rights.

Third, Professor Auster implies that ranchers who currently lease grazing lands from the federal government do not own any private property rights in the public lands. He argues that these usufruct rights are similar to the "implicit rights" that public workers have in job security. This analogy is incorrect and misleading.

Ranchers' usufruct rights are much different than public workers' "implicit rights" to job security. Unlike public workers, ranchers purchase their usufruct rights.[3] This occurs when ranchers pay private premiums for private lands that have public leases attached to them. These usufruct rights are, therefore, not only purchased, but they are recognized by the Internal Revenue Service and valued for purposes of determining inheritance taxes.

Although Professor Auster and I agree that public lands should be privatized, we have a fundamentally different view of the theory of justice and its relationship to the establishment of property rights. Professor Auster believes that the state should be invested with the original rights in the nation's natural resources, and that the state should then sell these "assets for what they are truly worth" instead of "in effect giving them away."[4]

My position is based on John Locke's theory of natural rights.[5] This theory does not suggest that the original rights to property should be invested with the state and then sold to the highest bidder. Rather, the fundamental tenet of natural rights theory is that rights should be originally invested with those who discover, work, and invest in resources with their energy and savings.

My proposal for privatizing public grazing lands not only protects existing holders of usufruct rights (rights that have been paid for and are recognized), but it also formulates a method for establishing absolute rights by a process that is in keeping with the natural rights theory of justice.[6]

[3]This statement does not apply to those private ranch lands that, since the passage of the Taylor Grazing Act, have never been transferred in an "arms length," market transaction.

[4]Auster, p. 869.

[5]For an excellent exposition of this theory of justice and its relation to property rights, see Murray N. Rothbard, "Justice and Property Rights," in *Property in a Humane Economy*, ed. Samuel L. Blumenfeld (LaSalle, Illinois: Open Court, 1974).

[6]It is important to mention that we are not starting the process of privatization from a pure state of nature. Hence, I have accepted the current state of affairs and recognized both the existing usufruct rights of ranchers and those of the government as a lessor of grazing rights. Given the acceptance of existing government and private grazing rights in public lands, my privatization proposal protects these rights and then applies the "homestead principle"—a principle derived from the natural rights theory of justice.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

A NOTE ON LAW, PROPERTY RIGHTS, AND AIR POLLUTION

John R. Lott

Introduction

Murray Rothbard (1982) fails to place the Coase theorem in its proper intellectual perspective as a contribution to economics and misses the power of Coase's observation. The ironic part is that his misrepresentation of this theorem helps to maintain an unfortunate and unnecessary rift between many whom, I believe, share a similar methodological approach to economics.

The Coase Theorem

Rothbard has failed to prove his point that there are "problems" inherent in the Coase theorem. In fact, the Coase theorem is true by definition. If transaction costs are lower than the gains from agreement and there are no wealth effects, then resource allocation will not be altered by the redistribution of property rights. If such conditions are not met, then resource allocation can be altered.

Let us start with Rothbard's example of the farmer and the railroad. Coase's point is that where the above conditions for transaction costs and wealth effects are met, the holder of the property rights (suppose it is the railroad) must take into account the reduced profits he is imposing on the other party.[1] The opportunity cost to the railroad is the payment the farmer is willing to make to stop the pollution. Transaction costs need not be "zero," but only smaller than the gains that can be realized by agreement between the parties.

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

The author is a Ph.D. Candidate in Economics at the University of California, Los Angeles, Calif. 90024.

[1]In Rothbard's discussion, it is unclear whether he is thinking in terms of physical damage or in terms of foregone profit (p. 57).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Rothbard's reference to the theorem deliberately ignoring "psychological factors" is puzzling (p. 58). There are two possible things that he might mean by this. The first and most obvious interpretation is that these "psychological" costs the railroad is imposing on the farmer are in some way different from other pecuniary costs. If this is really what he meant, then he is incorrect. Whether we are concerned with the railroad reducing the farmer's profits by $100,000 or $100,000 plus an additional $900,000 in nonpecuniary losses, the analysis is unaffected. The opportunity cost to the railroad producing smoke is now the $1 million the farmer would be willing to pay to have him stop. If the resulting output from the smoke is not worth at least $1 million, it is irrelevant to whom the rights are assigned since the railroad will not run in either case. If the railroad's profits from running are more than $1 million, the railroad will run. Thus Coase's analysis is entirely consistent with the subjective nature of cost. There is only one point that I can think of that can be brought up in this regard. Supposedly, the subjective nature of these costs could lead to bluffing on the part of negotiators, but this is hardly the only source from which bluffing can arise. If this is the point, it should not be treated any differently.

This brings us to a second possible interpretation of Rothbard's objection to the Coase theorem. This second argument is advanced by Walter Block (1977) in a paper Rothbard cites.[2] The analogous argument to the railroad and farmer is that while the farmer places this additional $900,000 value on the orchard, he neither "has the money" to pay the railroad up to $1 million (if the railroad's foregone profits were that high) nor would he want to pay that much money, for if he did he would no longer want to own the orchard. If Rothbard meant either one of these points, then the response is simply that he has violated the zero wealth effects assumption of the theorem. That is, the level of his wealth does determine whether the farmer will purchase the nonpecuniary benefits he receives from running the orchard. Wealth effects do not exist in the case of a strictly profit-maximizing firm, but only where individual consumption is occurring as in the case Rothbard mentions.

Ethics and the Legal System

Neither Ronald Coase nor Harold Demsetz would argue that transaction costs are always low enough or that wealth effects are always

[2]Rothbard's statement (p. 59, n. 6), that "there may well be farmers so attached to their orchards that *no price* would compensate them," leads one to believe that, like Block, he is forgetting Coase's assumption of zero wealth effects.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

unimportant enough so that resource allocation is invariant with respect to any given distribution of property rights. In fact, the Coase theorem gains a large part of its usefulness because it is still a useful policy tool even when these two conditions do not hold. The argument is that total wealth will be maximized if property rights are distributed so that we get the same outcome we would get if these two conditions were met. No one argues that "common-law judges will always arrive at the socially efficient allocation of property rights," but Demsetz does argue that it is likely that they will because any allocation of rights which does not maximize total wealth will be challenged more often than one that does. Thus, over time the "efficient" ones should predominate.

Rothbard does correctly point out that assigning property rights does create wealth transfers, but he is wrong to imply that those who mention the Coase theorem are unconcerned with this fact—Coase and Demsetz do see value judgments about who should receive this transfer playing an important role. What Rothbard should correctly criticize economists for is that they either explicitly or implicitly claim that everyone values a dollar equally. Ideally, economists would advocate lump sum taxes on those who gain the wealth transfers so that they could claim the change was Pareto optimal. But as with many assumptions by economists, this is not what we see in the real world. Economists must then make completely arbitrary assumptions about the valuation different people place on any given dollar in order to define "socially" efficient outcomes.

Historical Importance of the Coase Theorem

The importance of the Coase theorem lies not only in its ability to explain why certain externalities are internalized (for instance, Demsetz 1967) or in explaining decisions by the courts, but primarily as a basis from which economists can begin to analyze and solve problems. Surely the defenders of the Coase theorem realize the assumptions are usually an oversimplification and any model must be gradually expanded from these restrictive assumptions, but it has proven very useful. Before Coase, many economists would argue that "market failure" existed in a certain context and then automatically argue for government intervention, because they implicitly assumed the costs of government action were zero. Coase's point was that if we make the same assumptions with regard to the costs of market transactions, there would be no reason for the government to intervene. It was a simple but very powerful observation.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Other Observations and Conclusions

Unfortunately, many of Rothbard's arguments in the rest of his paper are based on his misunderstanding of the Coase theorem. One interesting point that Rothbard raises, but does not defend, though I am sympathetic with him, is why the law should be concerned only with physical coercion and not with other types of costs you can impose on others (p. 60). After all, is not physical coercion just one type of cost we can impose? If I offer someone $1 million to jump out a window, I am imposing a cost on him if he declines to jump. There is some offer at which the individual will be indifferent between losing the offer and the threat of physical harm.

In summary, Rothbard's piece is disappointing in that he misunderstands the opposing arguments. The whole debate is especially unfortunate since it is between natural allies (for instance, both stress the subjective nature of cost and that all costs are opportunity costs).[3] It would be indeed unfortunate if those who can benefit from such tools as the Coase theorem rejected them out of hand.

References

Alchian, Armen A. "Cost." *International Encylopedia of the Social Sciences*, Vol. 3 (1968), pp. 404–15. Reprinted in *Economic Forces at Work*. Indianapolis, Ind.: Liberty Press, 1977, pp. 301–33.

Block, Walter. "Coase and Demsetz on Private Property Rights." *Journal of Libertarian Studies* (Spring 1977): 111–15.

Coase, Ronald H. "The Problem of Social Cost." *Journal of Law and Economics* 3 (October 1960): 1–44.

Demsetz, Harold. "Toward a Theory of Property Rights." *American Economic Review* 57 (May 1967): 347–59.

Rothbard, Murray. "Law, Property Rights, and Air Pollution." *Cato Journal* 2 (Spring 1982): 55–99.

[3]For a clear statement on the UCLA-Chicago approach to "cost," see Alchian (1968, pp. 404–15).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

BOOK REVIEWS

The Supply-Side Solution
Edited by Bruce Bartlett and Timothy P. Roth
Chatham, N.J.: Chatham House Publishers for
the Manhattan Institute, 1983. 289 pp.

As accepted economic theory, orthodox Keynesian economics is dead. It has been executed by experience. But though its life as a reputable economic theory is over, Keynesian economics still lives on in the form of political expediency. Few politicians can resist the fundamental notion of Keynesian economics—that demand, especially demand exerted though the political process, translates quickly and painlessly into production. The hope and promise of supply-side economics was that it would replace Keynesian economics on two fronts: First, by providing a solidly based theoretical alternative to Keynesianism, and second, by providing politically attractive policy recommendations. The first objective has surely been accomplished, as evidenced by the collection of articles in *The Supply-Side Solution*, edited by Bruce Bartlett and Timothy P. Roth. But the second objective has encountered serious difficulties.

The political dimension of the problem faced by supply-side economics is best appreciated once its purely economic features are examined. It is in this sense that one can usefully read *The Supply-Side Solution*. The articles in this volume focus on some important economic questions: How is supply-side economics different from Keynesian economics? What are the limitations of Keynesian economics? In what ways does movement from the Keynesian to the supply-side approach constitute improvement in theory and policy? What is the current state of the U.S. economy? What would be the effect on the tax base and tax revenues if tax rates were cut? Can supply-side economics succeed?

To establish that these questions are worth addressing, one must first dismiss the belief that supply-side economics is simply a fad that grew out of the rhetoric of the Reagan campaign. Bartlett and Roth, in their introduction, and John Tatom, in his opening article, "We Are All Supply-Siders Now," do this very effectively. They show that supply-side economics is solidly grounded in economic analysis that goes back at least 200 years to the publication of *The Wealth of Nations*. In Adam Smith's view, and in the view of economists in general until the 1930s, production

Cato Journal, Vol. 3, No. 3 (Winter 1983/84). Copyright © Cato Institute. All rights reserved.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ultimately determines the wealth of a nation. It is this emphasis on production that distinguishes supply-side economics from Keynesian economics. Norman Ture emphatically points out in his article, "The Economic Effects of Tax Changes: A Neoclassical Analysis," that the purpose of a tax cut is to increase incentives to produce, not to increase disposable income and current consumption. Supply-siders are concerned with the effect of marginal tax rates on relative prices, rather than with the effect of average tax rates on disposable income.

In his article, "The Breakdown of the Keynesian Model," Paul Craig Roberts provides a devastating critique of the Keynesian approach to macroeconomic policy—an approach that ignores or downplays the incentive effects of changes in marginal tax rates. For example, it has been argued that reducing the marginal tax on labor income will have little, if any, effect on labor supply because the increased return to effort will be offset by increased income, which will prompt workers to consume more leisure. But Roberts neatly points out the fallacy of composition inherent in this argument. If one individual experiences an income tax reduction, he will be able to maintain his consumption of goods and services while increasing his leisure and producing less. However, if everyone receives an income tax cut, there will be no aggregate income effect since there will be no automatic increase in output. The income effect cannot come into effect until people respond to the tax cut by producing more. Therefore, the income effect can only moderate the incentive effect on a supply-side tax cut; it cannot completely offset it.

Michael Evans, in "The Bankruptcy of Keynesian Econometric Models," points to the hopeless inaccuracy of econometric models that attempt to reduce the economy to a series of equations based on Keynesian assumptions. He makes a convincing case that such models are naive in the extreme. But the same is true of the econometric models based on supply-side assumptions that Evans is recommending. And this is independent of the validity of the supply-side perspective. The type of information needed for the forecasting big-model builders claim to be capable of is simply too subjective and diffused to be meaningfully aggregated by any cadre of experts. The problem with all of these models is that their scientific aura beguiles bureaucrats and politicians into the pernicious belief that they can steer the economy along the appropriate path with the right mix of monetary and fiscal policies. The advantage in returning to the supply-side perspective is not in having supply-side fine-tuners replace Keynesian fine-tuners. The advantage is in gaining the understanding that in the long-run a stable and predictable incentive structure is important to economic progress, and that economic fine-tuning of any type is inimical to such an incentive structure.

Most of the articles in *The Supply-Side Solution* attempt to glean from the empirical evidence just what impact supply-side incentives will have on the economy. Michael Boskin makes a strong empirical case for a proposition that seems rather obvious, but one the Keynesians have been

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ridiculing for years. The proposition is that private saving will increase in response to an increase in the after-tax rate of return. Several implications flow from this, not the least important of which deals with the likely impact of reducing the marginal tax rate on capital income. Given the saving response that Boskin found, and empirical measures on the substitutability between capital and labor, there is reason to believe that reducing the tax on capital income will transfer gross income from capital to labor.

Robert Keleher follows with an article surveying some of the empirical evidence on the likely effects of a supply-side tax cut. He argues that the estimates probably understate the positive impact of these cuts. Arthur Laffer, after developing an analytical framework for examining the economic implications of marginal tax cuts, contrasts the economic situation in the early 1960s with that of the 1970s. Drawing on this comparison, he concludes that cutting taxes along the lines suggested by President Reagan in early 1981 is a reasonable approach to balancing the budget. Laffer, however, does not mention the impact monetary policy might have on his predictions, something he would certainly do if he were revising his article today.

The next three papers apply sophisticated econometric techniques to ascertain whether or not the tax policy of particular governments may have actually moved tax rates into the prohibitive region of the Laffer curve. Using a large econometric model and a range of labor supply elasticities obtained from existing studies, Don Fullerton concludes that tax policy probably has not taken the U.S. economy into the prohibitive region of the Laffer curve. Charles Stuart, using an approach roughly similar to Fullerton's, concludes that taxes in Sweden have almost certainly moved that country into the prohibitive region. Looking at local tax policy in the city of Philadelphia, Ronald Grieson finds that Philadelphia is near, if not at, the peak of the Laffer curve.

Several other notable papers follow. These papers, broadly speaking, conclude that the productive incentives being emphasized by supply-side economists cannot be ignored without risking serious and adverse long-run consequences to economic performance. Aris Protopapadakis concludes that volume with an article entitled, "Supply-Side Economics: What Chance for Success?" In keeping with most of the previous articles, Protopapadakis concludes that supply-side tax cuts can motivate important gains in output and productivity over the long run, but are unlikely to generate much gain in the short run. This long-run, short-run distinction, a distinction mentioned by many of the authors in this volume, is crucial in answering the question that Protopapadakis asks but never answers: What chance for success?

From a strictly economic perspective, there is no question that supply-side economics recommends policy prescriptions that will be successful in the long run. But unfortunately, the real success of supply-side economics depends as much, if not more, on political considerations as on

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

economic considerations. And the political process is pathologically shortsighted. As the former prime minister of Great Britain, Harold Wilson, once said, "A week is a long time in politics." It is this myopic view that made Keynesian economics so politically acceptable and presents supply-side economics with its greatest challenge.

Stimulating the economy before the next election with demand-side policies is relatively easy. Real improvement in the economy's productive capacity, however, takes sacrifice, hard work, and patience—attributes that hold little appeal for the free-lunch crowd in Washington. As much as one may fault the more extreme supply-siders who argued that tax cuts would immediately generate greater productivity and more tax revenue, such free-lunch claims may have been the only way for supply-siders to get their policy program on the political agenda. The success of supply-side economic policy, however, will ultimately depend as much on constraining shortsighted political proclivities as on reestablishing productive economic incentives.

In the meantime, it is important that supply-side economics be correctly perceived as grounded in serious economic analysis and as capable of improving the long-term productive capacity of the economy. *The Supply-Side Solution* is an important contribution in this regard. It provides us with a series of articles by serious scholars who make a compelling case that supply-side economics is a viable long-run solution to our current economic problems.

Dwight R. Lee
Center for Study of Public Choice
George Mason University

Development Without Aid
Melvin B. Krauss
New York: McGraw-Hill, 1983. 208 pp.

Melvyn Krauss has written a book that explores not only the policies that promote Third World development—primarily sensible domestic economic policies—but also those that do not, particularly foreign aid. Krauss' message is all the more important since Congress voted to give the International Monetary Fund (IMF) an additional $8.4 billion in an attempt to bail out insolvent Third World debtors and their Western banking creditors. Unfortunately, *Development Without Aid* suggests that this short-term palliative may ultimately hinder Third World development.

By almost any measure, the problems besetting most of the developing world are severe: dismal economic growth rates, millions in abject poverty and near starvation, and multibillion dollar international debts. For a solution, Third World leaders have turned to international politics and wealth redistribution, devoting their energies to building an active transnational redistributionist movement—a phenomenon left unexamined by Krauss. In doing so, they have wasted valuable intellectual and eco-

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

nomic resources that would have been better devoted to private developmental efforts.

The nonaligned movement originally focused on political neutrality in the Cold War, but soon turned to economics. In 1964 the Group of 77, or G-77, as the developing-country political lobby is called, was formed; it pressured the West for trade preferences and increased loans and aid. A decade later the G-77 used its bloc voting power in the United Nations General Assembly to approve the "Declaration on the Establishment of a New International Economic Order" and the "Charter of Economic Rights and Duties of States." The charter endorsed the right of countries to nationalize businesses and form mineral-producing cartels; the declaration demanded additional foreign aid, majority control of international financial institutions such as the IMF, and cancellation of previously incurred debts.

In succeeding years, the G-77 has used every available international forum, including UNCTAD, the Third United Nations Conference on the Law of the Sea, UNIDO, the Commission on Transnational Corporations, and UNESCO, to press for massive wealth and technology transfers from the industrialized nations. Tanzania's president, Julius Nyerere, a prime proponent of the redistributionist ideology, has told Western audiences that "In one world, as in one state, when I am rich because you are poor, and I am poor because you are rich, the transfer of wealth from the rich to the poor is a matter of right; it is not an appropriate matter for charity."[1]

As morally and intellectually offensive as such sentiments are, the greater pity is that as long as people believe them—that underdevelopment is the fault of the industrialized nations—the problem will get worse. Developing country politicians will continue to promulgate faulty domestic economic policies and promote destructive foreign aid programs.

Krauss challenges the conventional wisdom about Third World development in a number of ways. For example, he implicitly questions the use of aggregate statistics to describe all developing countries, showing that the neighboring African nations of Ghana and the Ivory Coast, for instance, have highly divergent economic growth rates. Moreover, he details the tremendous economic success of what he calls the "Gang of Four"—Hong Kong, Singapore, South Korea, and Taiwan—despite the depression throughout much of the underdeveloped world.

Krauss also shows that, despite the interdependence of the global economy, "intelligent *domestic* economic policy is the essential ingredient for economic prosperity in Third World nations" (p. 8). Among the national policies that he finds particularly destructive are those in the "social-democratic tradition of development finance": a large and activist government, high taxes, state development projects, and vigorous income redistribution.

[1]In P. T. Bauer and B. S. Yamey, "Against the New Economic Order," *Commentary* (April 1977), p. 27.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The problem with this development philosophy, which holds sway over so many Third World politicians and Western developmental economists, is that high taxes and large government projects discourage private investment by reducing both the private capital available and the incentive to invest in private projects. As a result, Krauss concludes, the very business activity necessary for job creation and economic growth is choked off, causing even a highly advanced and functioning public infrastructure to be of little value. Krauss argues that building an economic framework is part of, not a prerequisite for, development; "the absence of infrastructure is more a sign of economic stagnation than a reason for it" (p. 20).

Income redistribution also hinders development. The high taxes necessary to level incomes reduce the reward for entrepreneurial activity, discouraging individuals from taking risks, exploiting job-creating opportunities, and accumulating human capital. Krauss finds that Costa Rica, Uruguay, El Salvador, and Ghana all have pursued economic equality and extensive social welfare systems at the expense of wealth creation. The poor would have been better off in rich, nonegalitarian countries—ones that consciously promoted economic growth—than these poor, redistributionist ones.

Krauss also examines three other counterproductive domestic policies regularly carried out by activist governments. The first is protectionism, which raises consumer costs and inefficiently wastes valuable resources. Protecting domestic industries also effectively taxes export businesses by increasing competition for limited economic resources, raising their cost. (Some countries also tax their export industries directly.) Such a policy is foolish, for, as Krauss points out, "a healthy export sector is essential to sustained economic growth" (p. 12). Notably, the Gang of Four nations are all major exporters.

Second, many developing nations suffer from what Krauss terms "the error of imitation." In an attempt to emulate the "industrialized model," Third World governments invest in heavy industries like steel and petrochemicals and prestige companies like national airlines, even though such projects will never be cost-effective. Even worse, they drain away scarce capital resources from more productive private investments and keep the countries heavily indebted.

Lastly, Third World regulation of multinational corporations (MNC's) by, for example, taxing capital inflows, reduces economic activity and the influx of badly needed technology and capital. Krauss calls MNC's "the key institution in the world economy facilitating the transfer of prosperity from the industrialized countries to the developing ones" (p. 126).

Krauss ties these points together in a fine discussion of the economic policies of the late Shah of Iran. To recreate the Persian empire, the Shah expanded the role of government, levied high taxes, nationalized companies, built domestic heavy industries, closely regulated business,

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

created a burdensome social welfare state, and adopted extensive protectionist measures. Though commentators have given the mullahs the most credit for bringing down the Shah, Krauss concludes "it is doubtful whether they could have succeeded without the help of other less-religious groups like the traditional bourgeoisie, small businessmen, [and] new technical elites" (p. 102) who were harmed by the failure of the Shah's economic policies.

Though domestic policies are the most important determinant of the economic success of a nation, *Development Without Aid* explores some international policies that can help the Third World. The most important is free international trade. Another is international monetary reform. Krauss says the United States needs to make the dollar more attractive as a reserve asset for other nations, but warns against allowing an expanded IMF—one demand of the G-77—to serve "as a world central bank." Our experience with a politicized United Nations demonstrates the danger of subordinating the international economy to similar pressures.

Lastly, Western domestic policies that promote Western economic growth also benefit the developing world. Krauss demonstrates that increases in industrial production in the West will directly lead to increases in Third World primary product exports, and indirectly to increases in their industrial production as well, because they will become comparatively cheaper and more cost competitive as locations for manufacturing enterprises. Therefore, the industrialized nations, by subsidizing uneconomic special interests, creating extensive social welfare programs, and imposing high taxes, not only directly slow their own economic growth; they also indirectly hinder Third World progress.

But the most important contribution of *Development Without Aid* is detailing which international policies do not help lesser-developed nations—particularly foreign aid. Krauss builds on the pioneering work of economist P. T. Bauer to demonstrate that foreign aid often harms, rather than helps, Third World peoples.[2]

For example, foreign aid causes the recipient nation's currency to appreciate, reducing the competitiveness of its export industries. Yet earnings from a growing export industry will do far more to promote long-term development than politically unstable aid programs.

International aid also allows developing nations to adopt damaging domestic economic policies for political reasons. Krauss observes that "if governments can escape the burdens of their foolish economic policies, and foreign aid neutralizes such costs, governments have no incentive to discontinue them" (p. 158).

Another problem, which Krauss does not explore, is the concentration of additional power in the hands of Third World governments. In many developing nations, the government already controls what few resources

[2]See, for example, P. T. Bauer, *Dissent on Development* (Cambridge, Mass.: Harvard University Press, 1971); and idem, *Equality, the Third World, and Economic Delusion* (Cambridge, Mass.: Harvard University Press, 1981).

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

exist in the society; the state is the only arena in which people can gain power, influence, and wealth. Foreign aid, by increasing the money available to the government, increases still further the comparative advantage of entering politics rather than private business. This further drains the private sector of talented people and reduces private developmental efforts.

Krauss reserves his sharpest criticism for the multilateral aid organizations, particularly the World Bank. He points to its pattern of financing government energy and industrial projects, "crowding out private capital in areas in which private capital has a comparative advantage" (pp. 167–68). Even worse, the bank has underwritten such barbarous practices as the forced relocation of a half million families in Indonesia and the collectivization of farmers in Tanzania.

Krauss' critique of foreign aid is supported by two other recent books. In *The Destruction of a Continent*, Karl Borgin and Kathleen Corbett argue that foreign aid has been a "catastrophe" that has disrupted "the natural development of Africa."[3] And Thomas Sowell, in his powerful work *The Economics and Politics of Race*, singles out Tanzania, the recipient of the most foreign aid per capita in the world, "as a striking example of the effects of international wealth transfers."[4] Over the past decade output per worker has dropped by half and half the industries nationalized by the government have gone bankrupt.

Development Without Aid is not without its flaws, however. Krauss' fascination with supply-side economics leads him to proclaim that "economic growth helps the poor not only because of its effect on private incomes but also because economic growth allows public consumption—public housing, public health, education—to increase rapidly" (pp. 40–41). But why does he assume "public consumption" is in the public's interest? Public housing in America has had horrible consequences, including for the poor. The fundamental point is simply that only a growing economy provides the resources necessary to take care of the disadvantaged in society. If no wealth is created, there is none for anyone.

Krauss also endorses political involvement by MNC's, arguing "that the multinationals were able to use their legal influence to rid Chile of a government that had brought untold economic misery to the country is to their credit" (p. 134). The problem, of course, is that what actually replaced the Marxist Allende was the far more brutal and misery-creating Pinochet junta. MNC's are as likely as any indigenous special-interest group to use political influence to enrich themselves at the expense of others.

Additionally, the adverse impact of political repression on economic development is ignored by Krauss. Police states, many underwritten by the United States, stifle initiative and ingenuity, necessarily discourag-

[3](New York: Harcourt Brace Jovanovich, 1982), p. 188.

[4](New York: William Morrow and Co., 1983), p. 240.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ing economic endeavor. Restrictions on the free flow of information and travel also hinder business communication and operations. Just as economic freedom is necessary to preserve political freedom, political freedom underlies economic freedom.

Nevertheless, *Development Without Aid* is extremely valuable. Krauss has convincingly shown that the West should not fall for the guilt syndrome propagated by the G-77 and its intellectual camp followers. That does not mean we should be indifferent to the plight of the Third World. As Boston University sociologist Peter Berger has put it, "immense anguish and pain, physical as well as moral, have been associated with the entry of these people into the common history of our age."[5] We can help ease that pain by undertaking policies that promote international development and by reducing our support for politically brutal and economically backward regimes.

But the fundamental answer to widespread poverty and economic stagnation in the Third World is to change the disastrous domestic economic policies of the developing nations themselves. By stifling economic incentives and ingenuity, wasting domestic resources, and discouraging foreign investment, they have guaranteed economic disaster. And no amount of money from taxpayers in other lands can bail them out. Instead, if these countries give economic freedom a chance, they will find that, in Krauss' words, "the international marketplace prove[s] a much more potent antidote to poverty . . . than the international transfer of income" (p. 190).

Doug Bandow
Senior Policy Consultant
Cato Institute

[5]Peter Berger, "Speaking to the Third World," *Commentary* (October 1981), p. 30.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Conflict

All Warfare Short of War

Edited by George K. Tanham

This quarterly journal focuses on conflicts short of formal war, including guerrilla warfare, insurgency, revolution, and terrorism. Articles also cover non-physical conflicts, such as those of an economic, social, political, and psychological nature. Issues will attempt to address some of the less visible and less publicized conflicts occurring in the world today.

Selected Articles from the Fourth Volume of CONFLICT:

Shattering the Vietnam Syndrome: A Scenario for Success in El Salvador

Liberation Theology in Latin America: Its Challenge to the United States

Unconventional Warfare: A Legitimate Tool of Foreign Policy

The Ethnic Factor in the Soviet Armed Forces

Soviet Nationalities in German Wartime Strategy 1941–1945

Managing the Ethnic Factor in the Russian and Soviet Armed Forces: An Historical Overview

The Soviet Union and Muslim Guerrilla Wars, 1920–1981: Lessons for Afghanistan

Soviet Central Asian Soldiers in Afghanistan

Tribal Marxism: The Soviet Encounter with Afghanistan

Issued Quarterly Volume 5 $60.00

Crane, Russak & Company, Inc.

3 East 44th Street, New York, N.Y. 10017, (212) 867-1490

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Editors:

Mogens Pedersen, *University of Odense, Denmark*
Derek Urwin, *University of Warwick, England.*

Editorial Board

Dag Anckar, *Abo, Finland*
Francis Castles, *Milton Keynes, England*
Hans Daudt, *Amsterdam, The Netherlands*
Gunnel Gustafsson, *Umea, Sweden*
Hans Dieter Klingemann, *Berlin, FRG*
Gianfranco Pasquino, *Bologna, Italy*
Annick Percheron, *Paris, France*
Geoffrey Roberts, *Manchester, England*
Julian Santamaria, *Madrid, Spain*
Manfred G. Schmidt, *University of Mannheim, F.R.G.*
Marie-France Toinet, *Paris, France*

1984: Vol. 12 (4 issues)
For libraries and institutes
US $ 69.50/Dfl. 181.00, including postage.
For individuals
US$ 32.75/Dfl. 85.00, including postage.
Back volumes are available on request

Ask for a FREE SAMPLE COPY

EUROPEAN JOURNAL OF POLITICAL RESEARCH

Official Journal of the European Consortium for Political Research

Unlike other journals the *European Journal of Political Research* does not exist merely as another scholarly publication.
Its principal objective is still to foster communication and collaboration about ongoing research across national and linguistic boundaries within Europe. Its programme for the 1980s now includes even more stimulating articles, more book reviews, and more news on current political research - essential reading for all those interested in political science.

Some recent articles:

Party Government in Public Opinion: A European Cross-National Comparison
Hermann Schmitt

Must Power Research be a Political Activity?
Gunnar Falkemark

Political Stability in European Democracies
Svante Ersson and Jan-Erik Lane

General Elections in Western Nations During 1982
Thomas T. Mackie and Richard Rose

International Negotiation: The Development of Central Concepts
Ronald P. Barston

Causes of Negotiation 'Failure'
Arild Underdal

The Welfare State and the Economy in Periods of Economic Crisis: A Comparative Study of Twenty-three OECD Nations
Manfred G. Schmidt

ELSEVIER

P.O. Box 330,
1000 AH Amsterdam,
The Netherlands.

52 Vanderbilt Ave.,
New York, N.Y. 10017

The Dutch guilder price is definitive. US $ prices are subject to exchange rate fluctuations.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"It's the very best journal of its kind. It is substantial, relevant, and a must for policy analysts, practitioners, and academicians."

—Amitai Etzioni, The George Washington University

Journal of Policy Analysis and Management

Editor: Raymond Vernon, Harvard University

The JOURNAL OF POLICY ANALYSIS AND MANAGEMENT is the official journal of the Association for Public Policy Analysis and Management.

Published quarterly, the **JOURNAL OF POLICY ANALYSIS AND MANAGEMENT** represents a vital international forum for the publication of outstanding contemporary research and analysis in the field. As a subscriber, you'll find incisive, original papers on every major area of domestic and international public policy, as well as articles on how technology and important analytical tools can further sharpen your policy-making skills. Reading JPAM, you'll engage in the mutual exchange of ideas with policy analysts, academicians, government managers, and corporate officials from all over the world. And you'll better define your own professional identity and role with the help of JPAM's cogent articles on ethics, tactics, and the inevitable dilemmas that confront policy-makers.

Recent issues have included such in-depth research as:

- The Congressional Veto: Shifting the Balance of Administrative Control—*Robert S. Gilmour*
- Professionals at Bay: Managing Boston's Public Schools—*Robert Wood*
- Is the Consumer Price Index a Fair Measure of Inflation?—*Richard W. Wahl*
- International Agencies and the Art of the Possible: The Case of the IEA—*Robert O. Keohane*
- Government Support of Technical Progress: Lessons from History—*Richard R. Nelson*
- Restraining Auto Imports: Does Anyone Win? —*Jose A. Gomez-Ibanez, Robert A. Leone and Stephen A. O'Connell*
- The Bird in the Hand: A Feasible Strategy for Gun Control—*Mark H. Moore*

Supported by such regular features as topical book reviews, listings of working papers on ongoing research, and case notes for public policy instructors, the **JOURNAL OF POLICY ANALYSIS AND MANAGEMENT** is your source for the most complete perspectives on advances in this rapidly moving field.

JOHN WILEY & SONS
605 Third Avenue
New York, NY 10158

Send to:
JOHN WILEY & SONS, 605 Third Avenue, New York, NY 10158

Please enter a one-year subscription to the JOURNAL OF POLICY ANALYSIS AND MANAGEMENT (4 issues).

☐ Individual $36 ☐ Institutional $44
☐ Special Discount for individual ASPA members $30
☐ Bill me. ☐ Payment enclosed.
Charge to: ☐ MasterCard ☐ VISA ☐ American Express

Card No. _____ Expiration Date _____

Signature _____

For subscriptions outside U.S. add $17 for surface postage, or $76 for airmail delivery. Payment for international orders must be in U.S. currency. Service begins when payment is received.

Name _____

Address _____

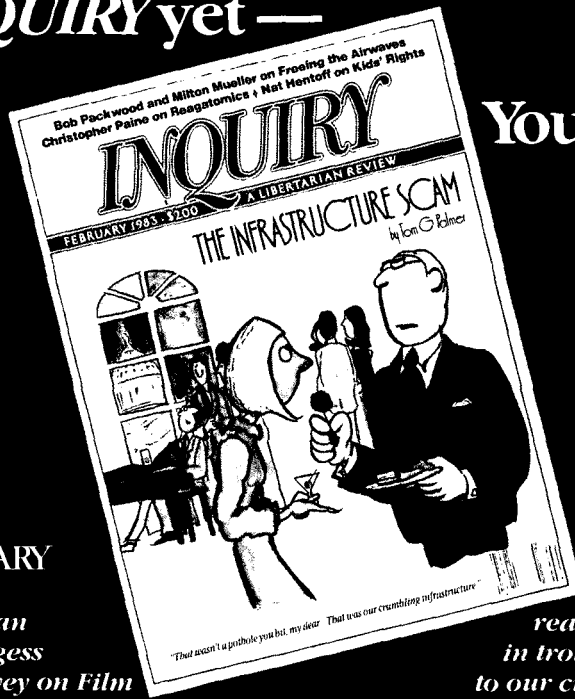
City/State/Zip _____

TO ORDER BY PHONE
CALL TOLL FREE 1-800 526-5368.
IN NEW JERSEY CALL COLLECT 201 342-6707.

41858A

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

If you haven't heard of *INQUIRY* yet —


Bob Packwood and Milton Mueller on Freeing the Airwaves
Christopher Paine on Reagatomics • Nat Hentoff on Kids' Rights
INQUIRY
A LIBERTARIAN REVIEW
FEBRUARY 1983 $2.00
THE INFRASTRUCTURE SCAM
by Tom G. Palmer
"That wasn't a pothole you hit, my dear. That was our crumbling infrastructure."

You will.

LIVELY COMMENTARY
- *Nat Hentoff*
- *Steve Chapman*
- *Anthony Burgess*
- *Stephen Harvey on Film*
- *Thomas Szasz* • *Donald Lambro*
- *George F. Kennan* • *William Tucker*

NEW INSIGHTS
The real reason Reagan's in trouble • threats to our civil liberties • avoiding nuclear war • understanding economic realities

SUBSCRIBE NOW. **Send me the next year of *INQUIRY* for $18.00.** 12 ISSUES

☐ My check is enclosed.

Bill my ☐ VISA ☐ MasterCard Account # _____ Expiration date _____

Signature _____

Name _____

Street _____

City _____

State _____ Zip _____

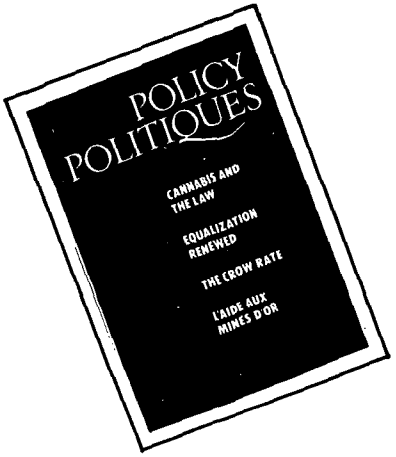
CJX22

Please return to:
INQUIRY
P.O. Box 2013
Mahopac, NY 10541

The New Voice in Current Events

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Canadian Public Policy
Analyse de Politiques



The No. 1

Public Policy journal

published in Canada

quarterly

Editor: Anthony Scott, MacKenzie King Professor, 1983–4, Center for International Affairs, Harvard University

Widely read by government officials, academics, students, and business executives

Articles – notes – book reviews – assessments of government documents and reports

Written by writers with established reputations

Vol. X no. 1 includes:

R.J. Wonnacott The Canadian Content Proposals of the Task Force on the Automobile Industry

J.S. Cohen, J. Rubin and R.S. Saunders Chasing the Bandwagon: Government Policy for the Electronics Industry

D.J. Fowler and M.J. Gordon The Effect of Public Policy Initiatives on Drug Prices in Canada

N.A. Michas Pension Funds: More Diversification

P.S. Spiro Exchange Rate Risk and the Cost of Foreign Capital

Special Offer: New subscribers may receive a free supplement with their 1984 subscription. Subscription rates: Individuals, $26; students, $16; institutions, $40; add $3 for mailing outside Canada. Special supplements on (1) Canada-US Trade and Policy Issues; (2) The Challenge of Inflation and Unemployment; (3) Property Tax Reform. Send orders to Canadian Public Policy, Room 039, MacKinnon Building, University of Guelph, Guelph, Ontario, Canada N1G 2W1.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

New Books Available from OG&H

National Security and International Stability

Edited by **Bernard Brodie, Michael D. Intriligator,** *and* **Roman Kolkowicz,** *Center for International and Strategic Affairs, University of California, Los Angeles*

These essays reasses the theoretical and policy validity of three decades of writing on the problems of national security.

432 pp. / 0-89946-172-7 / $30.00

Chinese Commercial Negotiating Style

by **Lucien W. Pye,** *Ford Professor of Political Science at M.I.T. and Consultant to the Rand Corporation*

This analysis of Chinese ways of negotiating contracts will be useful to people interested in the cultural and psychological factors at work in negotiating and bargaining situations with the Chinese.

109 pp. / 0-89946-168-9 / $20.00

Energy, Productivity, and Economic Growth

A Workshop Sponsored by the Electric Power Research Institute

Edited by **Sam H. Schurr, Sidney Sonenblum,** *and* **David O. Wood,** *The Electric Power Research Institute*

Using a consistent analytical approach, these papers develop reliable information to be used in studying interrelationships between energy supply and use and the overall productive efficiency of the economy.

480 pp. / 0-89946-178-6 / $35.00

China Policy for the Next Decade

The Atlantic Council's Committee on China Policy

Edited by **U. Alexis Johnson, George R. Packard** *and* **Alfred Wilhelm, Jr.,** *The Atlantic Council of the U.S.*

The book examines China policy from the perspectives of the U.S. and our European and Asian allies and concludes with recommendations for U.S. policymakers dealing with China.

CHINA POLICY FOR THE NEXT DECADE is by far the best statement on this subject I have read . . . It should be must reading for those responsible for shaping our China policy both in the U.S. and abroad. — *Richard M. Nixon*

c.300 pp. / 0-89946-279-4 / c. $27.50 cloth
c.300 pp. / 0-89946-182-4 / c. $12.50 paper

Western Interests and U.S. Policy Options in the Caribbean Basin

The Atlantic Council's Working Group on Western Interests and U.S. Policy Options in the Caribbean Basin

Edited by **James R. Greene,** *Dean at the School of Business, Monmouth College; Adjunct Professor at the Graduate School of Business, Columbia University, and former President, American Express International Banking Corporation, and* **Brent Scowcroft,** *former Assistant for National Security Affairs to the President of the United States*

This book examines the changing nature and problems of the Caribbean Basin, U.S. and other Western interests in the region, and the implications of recent trends for U.S. policy.

c. 290 pp. / 0-89946-181-6 / c. $25.00 cloth
c. 290 pp. / 0-89946-183-2 / c. $12.50 paper

To order send check to

Oelgeschlager, Gunn & Hain, Inc.
131 Clarendon Street
Boston, MA 02116
(617) 876-5100

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

What's in a name?

Journal of Labor Economics

A lot of other names:

Editor	Edward P. Lazear	H. Gregg Lewis	**Contributors**
Associate Editors	Glenn M. T. MacDonald	Christopher J. Flinn	
	George R. Neumann	Robert H. DeFina	
	Robert Topel	Sherwin Rosen	
Editorial Board	Orley C. Ashenfelter	H. Lorne Carmichael	
	Gary S. Becker	Robert H. Meyer	
	Reuben Gronau	Walter McManus	
	Robert E. Hall	William Gould	
	James J. Heckman	Finis Welch	
	Richard Layard	Giora Hanoch	
	Robert T. Michael	Marjorie Honig	
	Jacob Mincer	John Raisian	
	Sherwin Rosen	Chitra Ramaswami	
	Finis Welch	Barry R. Chiswick	
	Robert J. Willis	Burton A. Weisbrod	
	David A. Wise	Peter J. McCabe	

JOLE presents both theoretical and applied papers in the rapidly expanding field of labor economics. Topics include supply and demand for labor services, compensation, labor markets, distribution of income, labor demographics, unions and collective bargaining, and applied and policy issues in labor economics.

Published quarterly. 1-year rates: Individuals $30; Institutions $60; Students $24. *Add $3 for subscriptions outside the USA.* Visa and MasterCard accepted. Mail charge card information, purchase order, or payment to **The University of Chicago Press, Journals Division, P.O. Box 37005, Chicago, IL 60637.**

10/83

The University of Chicago Press

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

ECONOMY AND SOCIETY

A Quarterly Journal of the Social Sciences

Volume 12, 1983 will include:

Peter Gibbon	Gramsci, Eurocommunism, and the Comintern
Tzvetan Todorov	Epistemology of the human sciences
Otto Kirchheimer	The limits of expropriation
Wilhelm Hennis	Max Weber's 'Central Question'
Keith Tribe	Prussian agriculture — German politics: Max Weber 1892-7
Mike Gane	Durkheim: woman as outsider
Talal Asad	On body pain and truth in medieval Christianity

Annual subscription is £23.00 ($48.00).
Requests for subscriptions should be sent to:

Routledge Journals
Broadway House
Newton Road
Henley-on-Thames
Oxon. RG9 1EN

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

"Perhaps the most interesting aspect of the excellent Pergamon/Carnegie essays are their strong plea for modesty in U.S. foreign policy aims toward Central America. This implies shedding the illusion that outright military victory is possible." —The London Times

"Upstaging the Kissinger Commission Report . . ." —Newsweek

"The Carnegie panel . . . tackled the security issue head-on." —Newsday

"The Scholars and former government officials assembled by Carnegie offer convincing arguments." —In These Times

"The Carnegie group proposes a road to peace through careful negotiations leading to reconciliation in the Nicaraguan and Salvadoran communities. The Kissinger report does little to assure us that the cycle of despair and immobility will be broken or a new consensus will be developed. . . . Americans seeking a way out of what could indeed become our new quagmire would do better to turn to the Carnegie Endowment's CENTRAL AMERICA." —The New York Times Book Review

"Becoming a hot item among some Washington insiders." —The Christian Science Monitor

An authoritative book that brings the Central American crisis into sharp focus.

CENTRAL AMERICA
Anatomy of Conflict

edited by Robert S. Leiken
published by Pergamon Press,
in cooperation with the Carnegie Endowment for International Peace

Seventeen experts give you on-target investigations of the Salvadoran Guerillas; the Sandinistas; as well as Soviet/Cuban activities in the region. The authors also bring you in touch with the Central American military establishments—and present an in-depth analysis of the Washington policymaking process (including an unprecedented critique of Reagan administration policy by Viron Vaky).

Leiken and his team dig out the important points; explore the most crucial issues; and raise the most pertinent questions. CENTRAL AMERICA provides a fresh examination of Central American reality as a starting point for the construction of sound U.S. regional policy. It offers an incisive analysis of the political, economic, and military options for the U.S. in the region. This book also puts forward calculations of the political and military cost in human lives, dollars, internal consensus, and international prestige of an escalating U.S. involvement or direct intervention.

AUTHORED BY A TEAM OF POLICY EXPERTS.
The authors of this important guide include: the former National Security Advisor for Latin America, former Central American officials, American scholars and policy analysts including Richard Millett, Howard Wiarda, and Tom Farer. Many of these expert contributors have either testified before the Kissinger Commission, or have acted as special consultants to the Commission.

Table of Contents:

Preface
OVERVIEW: Can the Cycle be Broken? Robert S. Leiken

Legacies and Environment
1. Obdezco Pero No Cumplo (I Obey But I Do Not Comply), Christopher Dickey
2. The Burdens of the Past, Walter LaFeber
3. Praetorians or Patriots? The Central American Military, Richard Millett

Socialism and Sovietism
4. Origins of Sandinista Foreign Policy, Arturo Cruz Sequeira
5. The Salvadoran Left, Robert S. Leiken
6. The Soviets and Central America, Morris Rothenberg

Economic and Military Realities
7. The Costs of Alternative U.S. Policies Toward El Salvador 1984-1989, Theodore Moran
8. Military Threats, Actual and Potential, Joseph Cirincione and Leslie Hunter
9. Far From Hopeless: An Economic Program for Post-War Central America, Richard Feinberg and Robert Pastor
10. Feet People, Leonel Gomez

The Policy Process
11. Reagan's Central American Policy: An Isthmus Restored, Viron Vaky
12. At the Root of the Problem: Conceptual Failures in U.S.-Central American Relations, Howard Wiarda
13. At Sea in Central America: Can We Negotiate Our Way To Shore? Thomas Farer
14. Reagan Administration Policymaking and Central America, Barry Rubin
15. The Elusive Consensus: Congress and Central America, I.M. Destler

Index

To get your own copy, just fill in the Order Form. (This book is also available at your local bookstore.)

Order Form

Yes, I'd like to order:

Quantity

CENTRAL AMERICA: Anatomy of Conflict
$19.95 (hardcover) 351 pp. 030950 X _____

☐ Please send me information on other titles concerned with foreign policy/military affairs.

New York State residents must add applicable sales tax $_____

☐ Check ☐ Money Order enclosed Total Cost $_____

Please make checks and money orders payable to Pergamon Press.

Name _____

Address _____

City _____ State _____ Zip _____

Credit Cards: If using credit cards, please give your billing address. There is a $20.00 minimum on all credit card orders.

Please charge: ☐VISA ☐MasterCard ☐American Express ☐Diners Club

Number _____ Exp. ____

Signed _____ Date ____

Please mail this order form to:

PERGAMON PRESS, INC.
Maxwell House, Fairview Park
Elmsford, N.Y. 10523

B15 2/84 PB

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

Southern Economic Journal

Joint Publication of the Southern Economic Association and the University of North Carolina

The *Southern Economic Journal* is published four times a year, in January, April, July, and October, at Chapel Hill, N.C. 27514. The subscription price is $25.00 per year for members; $40.00 for nonmembers, domestic, and $46.00, foreign. Single copies: current issue $10.00 domestic, $11.50 foreign; back issues $11.00 domestic, $12.50 foreign. Circulation 4000. Address communications to:

Vincent J. Tarascio, Managing Editor
Southern Economic Journal
300 Hanes Hall, 019A
Chapel Hill, N.C. 27514

A $15.00 submission fee for SEA members and $25.00 for nonmembers must accompany all manuscripts except book reviews. Membership dues in the Association are: annual $25.00, contributing $42.50, life $325.00, institutions $325.00, student $12.50, retired $12.50. Membership dues include payment for a year's subscription to the *Southern Economic Journal*. Applications for membership should be addressed to Joseph Jadlow, College of Business Administration, Oklahoma State University, Stillwater, Oklahoma 74078.

"A revolutionary reappraisal of the American role in the world, of U.S. obligations to allies, of the very definition of what is required for our security."

—**Philip Geyelin**, *The Washington Post*

A provocative and unique analysis of President Reagan's proposed 1985 military budget by one of America's foremost advocates of noninterventionism. A former Pentagon official, Dr. Ravenal proposes significant reductions in U.S. foreign policy commitments as the only realistic way to substantially reduce military spending and the burgeoning federal deficit. ***46 pp. $3.95***

Defining Defense: The 1985 Military Budget

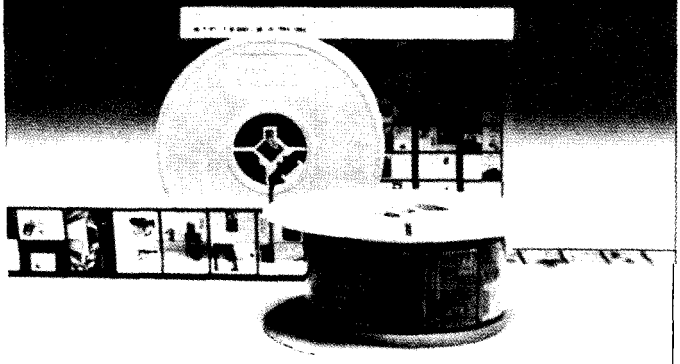
Earl C. Ravenal

Available from the Cato Institute, Dept. CJ 224 Second Street, SE Washington, D.C. 20003

CATO INSTITUTE

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

This publication is available in microform.



University Microfilms International

Please send additional information
Name _____
Institution _____
Street _____
City _____
State _____ Zip _____

300 North Zeeb Road
Dept. P.R.
Ann Arbor, Mi. 48106
U.S.A.

30-32 Mortimer Street
Dept. P.R.
London W1N 7RA
England

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

The Cato Institute

Founded in 1977, the Cato Institute is a nonpartisan public policy research foundation headquartered in Washington, D.C. The Institute is named for *Cato's Letters,* libertarian pamphlets that helped lay the philosophical foundation for the American Revolution.

The Cato Institute seeks to broaden the parameters of public policy debate to allow consideration of more options that are consistent with the traditional American principles of limited government, individual liberty, and peace. Toward that goal, the Institute strives to achieve a greater involvement of the intelligent, concerned lay public in questions of policy and the proper role of government.

The Cato Institute undertakes an extensive publications program dealing with the complete spectrum of policy issues. Books, monographs, and shorter studies are commissioned to examine the federal budget, Social Security, monetary policy, natural resource policy, military spending, regulation, NATO, international trade, and many other issues. Major policy conferences are held throughout the year, from which papers are published thrice yearly in the *Cato Journal.* The Institute maintains an informal joint publishing arrangement with the Johns Hopkins University Press.

In order to maintain an independent posture, the Cato Institute accepts no government funding. Contributions are received from foundations, corporations, and individuals, and from the sale of publications. The Institute is a nonprofit, tax-exempt educational foundation under Section 501(c)3 of the Internal Revenue Code.

The Watterston House headquarters of the Cato Institute

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED

5^{00}

THE RATIONALITY OF REAL REFORM

Without radical reform conflict is clearly in store. . . . Young participants desire to leave the system in search of more lucrative investments, and older participants, fearing for their benefits, desire to perpetuate the system. Whereas in a private competitive setting such a scheme would tend to terminate with the voluntary exit of the young, a social insurance system can perpetuate itself—but only as long as the majority chooses to use the powers of the state to do so. The relentless truth is that coercion cannot eliminate the desires of participants or the tension created by declining returns. Coercion simply determines in whose favor the conflict is resolved—at least for the time being.

. . . the lessons from history seem abundantly clear: the existing crisis in Social Security is decidedly not financial in nature, it is decidedly not "unexpected," and it rests squarely in the political and economic failures resulting from a loss of individual choice in 1935. The crisis is at base political; lodged in the institutional weaknesses of the program. If nothing else this crucial period in the history of Social Security should foster the development of competing ideas about the crisis, so necessary for rational decision-making in the future.

—Carolyn L. Weaver

The Crisis in Social Security: Economic and Political Origins (Durham, N.C.: Duke University Press, 1982), pp. 189–90.

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED